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# UNDERSTANDING THE IMPLICATIONS AND CONSEQUENCES OF THE PROPOSED RULE ON RISK RETENTION

## HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

APRIL 14, 2011

Printed for the use of the Committee on Financial Services

**Serial No. 112–27**

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# UNDERSTANDING THE IMPLICATIONS AND CONSEQUENCES OF THE PROPOSED RULE ON RISK RETENTION

**Thursday, April 14, 2011**

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 2:02 p.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Schweikert, Manzullo, Biggert, Hensarling, Neugebauer, Campbell, Pearce, Posey, Hayworth, Hurt, Grimm, Stivers; Sherman, Hinojosa, Lynch, Miller of North Carolina, Maloney, Perlmutter, Carson, Himes, Peters, Green, and Ellison.

Ex officio present: Representatives Bachus and Frank.

Also present: Representative Renacci.

Chairman GARRETT. Good afternoon. This hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises will come to order. And without objection, all members' opening statements will be made a part of the complete record.

At this time, I yield to myself for the first 5 minutes.

Today, we will be examining the ongoing rules and rule-writing of Section 941 of the Dodd-Frank Act. Section 941 of Dodd-Frank mandates that our financial regulators craft rules requiring entities involved in the securitization to retain a certain level of risk of the assets being securitized.

The intent of this was to better align the incentives among the chain of originators, the securitizers, and the investors. I have stated numerous times that risk retention, if it is done correctly, in theory can be a constructive addition. But I do have significant concerns with the rules as currently written and the many unanswered questions that they raise.

Some of my main concerns are not only with the policy implications of the rules but also, quite frankly, with the process and the manner in which some of the policies were included, and the explicit disregard, quite frankly, of congressional intent. Section 941(b) of the Dodd-Frank Act creates section 15G of the Securities Exchange Act, which specifically exempts all assets which are insured or guaranteed by the United States or an agency of the

United States. The rest of the section specifically says that Fannie Mae and Freddie Mac are not agencies of the U.S. Government.

With that said, it is hard for me to see how much more explicit this Congress could have been. It was not the intent to have the GSEs exempted from the risk retention requirement, yet the rule before us today allows for the GSEs to be exempted and it does so by claiming that their guarantee functionally acts as a formal type of risk retention. Quite frankly, this will severely hinder ongoing efforts by the Administration and Congress to encourage more private capital in our mortgage market and reduce taxpayer risk.

By a 34–0 unanimous vote last week in this committee, we passed legislation that I introduced which would attempt to ensure that the government and the private sector are treated equally with regard to risk retention. As most of you know if you know this committee, over the last several years there have not been a lot of committee pieces of legislation that have passed out of this committee in a completely unanimous vote like this did.

So in this case, this should be a clear intention to you that Congress believes that you need to alter your rule and follow the clear intention of Dodd-Frank on this topic. I look forward to working with each of you on this to ensure the final draft is structured in a way that does not put the private market at a disadvantage in the government.

Another one of my main concerns is the addition of servicing standards to the rule. While I agree that there are a number of problems that have occurred in the servicing sector, I do not believe that unelected bureaucrats, if you will, should be attaching unauthorized policy goals on the next train leaving town.

As you all know, I was on the Dodd-Frank conference committee. Over 6 days of discussion during the conference, I don't remember any time when servicing standards were contemplated, much less discussed during that time.

I certainly cannot find anything in Section 941 authorizing the regulators to include servicing standards in the rule. So it is Congress' role to examine the issues in the servicing industry and make specific policy proposals, not the regulators.

So these two instances—the exemptions of the GSEs and the inclusion of servicing standards—highlight my overreaching concerns about the manner in which this rule was drafted. In one instance, you have Congress specifically directing the regulators to do something and they did the opposite; in another instance, Congress didn't provide any authority or authorization to do something but they did anyway.

So I hope that you and the heads of the various agencies will reverse course on these issues and actually follow the letter of the law and the intention of Congress. This is just a microcosm of the absurdity, I guess, of trying to delegate over 300 rules affecting literally millions of people and businesses, not to mention the entire U.S. economy, to dozens of agencies and then mandating that it is all done in a year. I understand that.

Finally, in addition to this, there are many other important issues that Members need to learn about today, like the specific ongoing underwriting standards of QRM, how private mortgage insurance should factor into the criteria, and also the premium capture

cash reserve accounts requirements and its possible tremendous negative effects on the residential and commercial securitization market.

With that, the rule has a broad impact on so many people, our economy, and the recovery, it is critical that we get this right. So I hope today's hearing can begin to move us all in that direction.

And with that I yield now to—there he is—the gentleman from Massachusetts for—

Mr. FRANK. Thank you. Let me just say preliminarily, the ranking member of the subcommittee, the gentlewoman from California, Ms. Waters, is at a full committee markup of the Judiciary Committee right now on patent reform. That is also where Mr. Watt is, so that is a very significant issue and they will not be able to be with us because of that.

I want to talk just a little bit about the context of risk retention. The risk retention context is a very important one.

I believe that one of the most important factors that led to the crisis was the ability of people to make loans without bearing the risk of nonpayment of that loan; that was transformative in both a good way and a bad way. Thirty years ago, we had a situation where people who borrowed money were paying back the lender, and lenders frisked people pretty good before lending them their money. And then, because of liquidity outside of the banking system from a variety of sources and because of the ability to securitize through computers and other ways, we lost that discipline.

So it is very important that we put it back in the bill. I think it is one of the most important things in the legislation. And I should note that it does not simply apply to residential mortgages; it applies to commercial, to all manner of lending.

And this policy of people making loans without regard for the ability of the borrower to repay was a serious problem. So we have this legislation, and we did say that with regard to residential mortgages we would make an exemption if we could have other assurances that these were good loans—that is, the fundamental mechanism for making sure that loans are made prudently is the loss that a lender will suffer if the borrower can't pay it back, and that is the market discipline on the lender.

To the extent that securitization either evolved into this or severely attenuates that, we want some substitute. The Qualified Residential Mortgage is a substitute for that market discipline.

I want to make a couple of points. First of all, I disagree with those who are acting as if all residential loans in the future are going to have to come under that Qualified Residential Mortgage exception. It no doubt seems that way now. Change is hard for people to grasp.

We have smaller financial institutions that have made mortgage loans and kept them in portfolio because they didn't want to take the loss that comes when you go and securitize. We have some entities—Wells Fargo—that said they will make these loans and securitize them with risk retention.

Risk retention is not meant to stop securitization; it is meant to make it more responsible. And a 5 percent number ought not to be deterring anybody with responsible policies.

And there is the FHA. I agree, as the vote made clear last week, that we should not be exempting Fannie Mae and Freddie Mac through risk retention. I do believe that we have a very solid set of safeguards in the FHA, and that we should continue to work on, and I hope we will be further legislating on, those safeguards, but there is an argument for not having the risk retention apply there and I think you can do that in the FHA without it.

But there are, I hope going forward, going to be loans made outside of the Qualified Residential Mortgage. Having said that, I do believe that the Qualified Residential Mortgage, especially in this period when people need it, it is going to be very important.

And I am persuaded by a number of people that 20 percent is too high a number. What we are looking for—and we have to look at the statistics as to what experience has been, and I think it is a very good argument that you don't have to get to 20 percent.

It is also the case that there are qualitative things you can do with regard to mortgages, some of which we have done, to prevent bad mortgages. And that, I think, further gives us some assurance.

I will say, of those things that have been suggested as for the safeguards, private mortgage insurance does not seem to me to be one of those that can be a relevant factor here. I don't think that is going to discourage the bad loans. Insuring people against having made bad loan decisions does not seem to me to discourage them from making bad loan decisions.

So I am very pleased with the framework we have created. I think it is essential to reintroducing a healthy respect for risk into the lending system, not just in mortgages, but elsewhere; but I also believe that the arguments that 20 percent is too high a number are very persuasive and I look forward to further work on that.

Chairman GARRETT. I thank the gentleman.

To the chairman of the full committee, the gentleman from Alabama, for 2 minutes?

Chairman BACHUS. I thank the chairman for convening the hearing on credit risk retention as mandated by Dodd-Frank.

Securitization has both benefits and risk. While securitization of assets increases liquidity and lowers the cost of credit to homeowners, students, consumers, and businesses seeking financing, securitization can also create moral hazards by allowing originators and securitizers of assets to pass the risk of underlying assets on to investors. And of course, we certainly saw that in 2008 in a big way.

Section 941 of Dodd-Frank sought to reduce that moral hazard by better aligning the interests of sellers and buyers of asset-backed securities, which is a worthy goal. Proponents of this approach advocate or are advanced at requiring securitizers to retain some skin in the game, which will encourage them to take more care in selecting high-quality assets.

For risk retention to be successful, however, the standard must not stifle the securitization of loan products, thereby raising costs to consumers and cutting down on the availability of credit. The proposed release by the regulators on March 31st, I think recognizes the differences between asset classes, collateral, and financing structures and provides needed flexibility for securitizers to determine the most appropriate form of risk retention.

I particularly applaud the testimony of the Federal Reserve and the OCC, and there is a lot to associate myself with in your testimony.

But as with any proposal that runs several hundred pages, there are aspects of the rule that I think raise questions and concerns. For example, the regulators have chosen to address extraneous issues, which, in my opinion, are beyond the scope of Dodd-Frank, including mortgage servicing standards as part of the risk retention requirements. Also, the broad exemption provided to loans purchased by Fannie and Freddie, I think is problematic.

And I will close by saying this: I would associate myself with page seven of the Fed's testimony, where you say, "However, unlike the various other types of risk retention discussed earlier, which all involve the acquisition of an asset by the sponsor, the GSE's risk exposure is generally in the form of an unfunded guarantee, which would not satisfy the risk retention requirements of the proposed rules."

It really seems to be contrary to the intent and would, in my mind, unlevel a level playing field. And I know the intent of the Treasury, which has been announced, is to crowd in private investment in a crowded market, but I think that would work in the opposite direction.

I appreciate your testimony, and I appreciate your thoughts on this in approaching today's hearing.

Chairman GARRETT. Does the gentleman yield back?

Chairman BACHUS. Yes.

Chairman GARRETT. Mr. Hinojosa for a liberal 2 minutes?

Mr. HINOJOSA. Chairman Garrett, I ask unanimous consent to submit for today's record a letter from several civil rights groups opposing the 20 percent downpayment proposed in the risk retention rule, including the National Council of La Raza, the NAACP, Americans for Financial Reform, and others.

Chairman GARRETT. Without objection, it is so ordered.

Mr. HINOJOSA. I ask unanimous consent. Thank you.

Mr. Chairman, I appreciate you holding this important and timely hearing.

I want to welcome the witnesses to the subcommittee and I look forward to a continued dialogue with your agencies on the importance of homeownership to my constituents in South Texas along the Texas-Mexico border.

Mr. Chairman, I am concerned about the risk retention proposal we are addressing here today. We must restore sound practices in lending, securitization, and loan servicing without shutting out creditworthy borrowers.

However, requiring a minimum 20 percent downpayment for Qualified Residential Mortgages might have a negative impact on the ability of minority and first-time homebuyers to obtain an affordable mortgage and attain the American dream of homeownership. Furthermore, additional requirements mandating specific loan-to-value ratios might do more harm than good by unduly disadvantaging well-qualified borrowers who lack the resources necessary for large downpayments.

Mr. Chairman, whatever we do to address risk retention and the definition of Qualified Residential Mortgages, we should not allow

a proposal by any agency or agencies to move forward that would subject minority and first-time homebuyers to the same predatory lending that contributed substantially to the recent economic crisis. Requiring a 20 percent downpayment might have that effect. I hope that today's witnesses have taken this concern into consideration as they drafted the proposal on credit risk retention.

Again, I welcome the witnesses, and I yield back the remainder of my time.

Chairman GARRETT. The gentleman yields back.

The gentleman from Arizona, for 1 minute?

Mr. SCHWEIKERT. Thank you, Mr. Chairman. And I know I have only 60 seconds here.

I have actually been looking forward to this hearing. I have dozens and dozens of questions and I am sure our panel here will hit every single one of them.

One has to do with the servicing ending up as part of the discussion. Being someone who has a great interest in impairment servicing, should that be dealt with separately? Is the June 10th deadline for particularly comments—is that still on target or should that be extended?

And one of my greatest concerns here in regards to risk retention is, ultimately, what are we trying to accomplish? Is 20 percent the magic number? Is it 10 percent down with private mortgage insurance?

Is it some mechanic within, a strip on the bond, if the securitizer is willing to hold certain of the risk? What ultimately defines up and down through the market that additional guarantee for the final product, particularly on the bond side, that we are trying to protect?

Thank you, Mr. Chairman.

Chairman GARRETT. And the gentleman yields back.

Mr. Himes for 2 minutes?

Mr. HIMES. Thank you, Mr. Chairman.

And let me thank the panel for joining us today for what I think is a really interesting and important conversation. As I reflect on Dodd-Frank, I think the risk retention provision was an example of—as a matter of principle—smart public policy. This government could have faced a choice of trying to be blunt about what securities were too risky to be contemplated, and which were not—how the spectrum of risk might—how different securities might fall on a spectrum of risk, but we didn't.

We chose instead to do something very smart, which was to say, "Go out and invent some securitized product that we perhaps don't understand, but you will retain some exposure to whatever that beast is that you have created. You will eat your own cooking, to some extent." And that is a very smart principle within regulation.

The challenge, of course, is that these beasts have very, very different profiles. Some of them are extraordinarily risky, as we learned; some of them are not. Some of them are composed of U.S. Treasury debt.

And so the challenge, of course, for you is to figure out what the right level of retention is for different instruments. Dodd-Frank contemplated a 5 percent level with some flexibility.

It is really critical, I think, as you undertake your work—and you know this, of course—that risk retention not require capital levels so high that liquidity will be compromised. And that is a very real risk.

These securities are complicated. They have different profiles. Many of the securities under contemplation here were far removed from the problems that we watched in the last 3 or 4 years.

So I thank you for the work you are doing, and urge you to bear in mind that particularly now, in this economy, liquidity is essential. I point, in particular, to the CLO market, which the Federal Reserve indicated was perhaps a product that didn't require 5 percent retention, in which liquidity could be damaged if a 5 percent number were used.

Obviously, there are many, many other examples of this. I appreciate the complexity of your task. But as I stand for the principle of retention, which I think is absolutely right, I urge you to be very mindful that the process not damage liquidity, particularly in those instruments which were far removed from the problems that this country experienced in the last several years.

And with that, I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back.

The gentleman from Texas, for 2 minutes?

Mr. HENSARLING. Thank you, Mr. Chairman. I know votes are imminent, so I will attempt not to take up the full 2 minutes.

We all know that the world works off of incentives, and I like to have incentives properly aligned, so on the chalkboard, the whole risk retention rule certainly has an appeal to it. However, a prescriptive rule is not one I have a high level of enthusiasm for, and this one in specific I have great, great concern for.

I think it could impede private capital from coming back into the market. I fear it does not serve as a caution light but perhaps as an absolute stop sign. I am afraid this may be one more of the unintended consequences that we find in the Dodd-Frank legislation.

I must admit, as I was peeking and reading some of the testimony and some of the documents that have come across my desk, any time you get the mortgage bankers, the mortgage insurers, the Center for Responsible Lending, and the Congressional Black Caucus to agree on something, maybe this committee ought to pay a little bit of attention. So certainly, that is what I observed, Mr. Chairman.

Again, they are sounding the alarm and we need to pay attention. And I, again, fear that something that looked good on the drawing board may not prove so good in practice. And I personally am going to be laser-focused on removing all the barriers necessary to get private capital to come back into our mortgage markets.

I yield back to the chairman.

Chairman GARRETT. The gentleman from Texas yields back.

The gentleman from Texas referenced votes. I think we are going to try to—the recommendation is to plow right through this, but before we do that, we will hear from the gentleman, Mr. Lynch, for 2 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

I would like to thank our witnesses as well for appearing before us and helping the committee with this work. The risk retention

rule in Section 941(b), if properly designed and administered, will play a critical role for the mortgage industry and will be incredibly important to the members of this committee and to regulators to get right in order to avoid the recklessness that we saw in the last financial crisis as well as to try to balance out the need for greater credit availability.

The joint rule on the securitization of asset-backed security, which we all know played a central role in the recent financial crisis—Dodd-Frank requires banks or securitizers to keep some skin in the game for the loans that they are originating and bundling and selling to investors. Under the proposed rules, securitizers must retain a 5 percent portion of the credit risk for assets that they decide to sell to investors.

There is an important exemption, of course, and the regulators are able to determine what the exemption looks like. Now, my friend, the gentleman from Texas, has talked about the proposed rule to include a requirement of a 20 percent downpayment and the impact that that might have on credit availability to people in his district and mine as well, and there is also a provision here that it would require anyone from qualifying—excuse me. It would prohibit someone from qualifying if they had any delinquency or late payment over 60 days in the last 2 years.

That would probably eliminate a large portion of people who might otherwise qualify for a mortgage. And I think with the abundance of information we have on credit history, we should be able to come up with a more fine-tuned approach than simply saying someone missed a—was late on a cable bill or a utility bill for 60 days and therefore are ineligible for credit.

I am concerned about how this might affect the affordability of a 30-year mortgage. Congress has gone to great lengths to promote mortgage finance over the greater part of the last century. The GSEs were created because additional liquidity was needed in order to—for the market to provide long-term fixed-rate mortgages, and a 30-year fixed-rate mortgage was not affordable even to families with stable incomes.

As the rule is currently written, however, I am not sure the 30-year fixed-rate mortgage, an essential and valued product to the American homebuyer, will still be available except to the very wealthy. I look forward to hearing from our witnesses and I yield back the balance of my time.

Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman yields back.

Mr. Stivers, for 1 minute?

Mr. STIVERS. Thank you, Mr. Chairman, for calling this hearing on the proposed risk retention rules. And obviously, we all agree with the concept of risk retention. I think skin in the game makes a lot of sense.

I do have a lot of folks in my district who are related to the automobile industry. I have a Honda plant in my district that employs about 4,000 people and they rely on the asset-backed securities market for critical access to capital and ensuring that they can produce and sell cars. And I am a little concerned about the narrow crafting of the qualified automobile loan as well, and I would like to ask some questions about that a little later.

I think there have been a lot of questions about the QRM that I am anxious to ask some questions about going forward.

I look forward to hearing from all the witnesses. I want to thank the chairman for allowing me a little time, and I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back.

And with that, we have just been advised of a slightly different vote sequence following this, so we will begin the sequence of panelists.

Without objection, all of your written statements will be made a part of the formal record, and you are now recognized for 5 minutes.

Mr. Alvarez?

**STATEMENT OF SCOTT G. ALVAREZ, GENERAL COUNSEL, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

Mr. ALVAREZ. Thank you, Mr. Chairman.

Thank you, Chairman Garret, Ranking Member Frank, and members of the subcommittee. I appreciate the opportunity to discuss the implementation of the risk retention requirements of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

This statutory provision generally requires securitizers to retain some of the credit risk of the assets they securitize, often referred to as "keeping some skin in the game." The concept behind risk retention and securitization is that it promotes incentives for loan securitizers and originators to maintain appropriate underwriting standards and to monitor the credit quality of assets that they securitize.

By better aligning the incentives of securitizers with the incentives of investors in this way, risk retention requirements foster more liquid markets for loans, which increases the availability of credit to consumers and businesses and lowers the cost to borrowers. The Federal Reserve has joined with the other Federal agencies here today to invite the public to comment on a proposed rule that would implement the risk retention requirements of the Dodd-Frank Act.

In developing the proposal, the Federal Reserve and the other agencies carefully considered best market practices for risk retention used for various types of assets and various types of securitization structures. We also took into account how well these forms of risk retention performed during the recent market crisis.

The proposal includes a menu of options for retaining risk that allows securitizers to tailor securitization transactions according to market practice while at the same time meeting the statutory requirements to retain risk. This should encourage securitizers to closely screen and control the credit quality of the assets they securitize without unduly disrupting markets.

As provided in the Dodd-Frank Act, the agency proposal includes an exemption from the risk retention requirement for the securitization of "Qualified Residential Mortgages," or "QRMs." In keeping with the statute, the proposal is based on standards that are most associated with lower risk of default on residential mortgages, including conservative debt-to-income ratios, strong credit

history, and a significant downpayment requirement for purchase loans.

The statute contemplates that strong underwriting standards offset allowing the securitization to proceed without any risk retention requirement on the sponsor or originator. In addition to lowering the default risk, this approach is designed to improve access to and lower the cost of credit for creditworthy consumers.

A narrow QRM definition should improve access to credit and lower borrower cost by encouraging a deep and liquid market for residential mortgages that do not meet the definition of a QRM and fostering securitization of those loans. On the other hand, a broader definition of QRM that encompasses a much larger portion of the residential mortgage market could diminish access to credit for creditworthy borrowers because the small segment of the market left outside a broad definition of QRM may not be able to attract sufficient funding from the markets to make it practical for lenders to make the loans and for those loans to be securitized.

The risk retention requirements of the Dodd-Frank Act raise important and complex issues. The Federal Reserve and the other agencies here today look forward to receiving comments on the proposed risk retention rules from consumers, borrowers, lenders, securitizers, and all others who are interested in the proposal. We will weigh those comments carefully before acting on the final rule.

I thank you very much for your attention and am happy to answer any questions.

[The prepared statement of Mr. Alvarez can be found on page 62 of the appendix.]

Chairman GARRETT. And I thank you.

Ms. Cross?

**STATEMENT OF MEREDITH CROSS, DIRECTOR, DIVISION OF CORPORATION FINANCE, U.S. SECURITIES AND EXCHANGE COMMISSION (SEC)**

Ms. CROSS. Chairman Garrett, Ranking Member Frank, and members of the subcommittee, I am pleased to testify on behalf of the Commission on the topic of risk retention and securitization. On March 30, 2011, the Commission joined its fellow regulators in issuing proposals to implement the risk retention requirements in Section 941(b) of the Dodd-Frank Act.

The proposal would permit a sponsor to choose from a menu of four risk retention options and also includes transaction-specific options for three asset classes. A sponsor also would be required to establish a cash reserve account in certain cases.

The proposal would permit the 100 percent guarantee provided by Fannie Mae or Freddie Mac to satisfy their risk retention obligations, but only while they are operating under conservatorship or receivership with capital support from the United States. The proposal provides an exemption for ABS backed by Qualified Residential Mortgages as well as for ABS backed by commercial loans, commercial mortgages, or automobile loans that meet certain underwriting standards. It also would exempt certain other securitizations consistent with the Act.

The proposal comes from many months of collaboration and cooperation. The agencies have included numerous requests for com-

ment and we look forward to considering the comments as we work together to finalize the rules.

In addition to risk retention, the Dodd-Frank Act has other provisions that require Commission rulemaking for ABS and I would like to mention them briefly today. For example, Section 943 requires the Commission to adopt disclosure rules on the use of representations and warranties, which the Commission finalized in January. Also in January, the Commission adopted rules implementing Section 945, requiring ABS issuers in registered transactions to review the assets underlying the ABS and disclose the nature of the review.

Further, Section 942(a) eliminated the provision that allowed ABS issuers to automatically stop reporting under the Exchange Act and granted the Commission authority to issue rules allowing ABS issuers to stop reporting. In January, the Commission proposed rules to permit suspension of reporting in certain limited cases.

In addition to these Dodd-Frank Act ABS rulemakings, in April 2010, prior to passage of the Act, the Commission proposed substantial enhancements to the Commission's ABS rules. Importantly, the Commission's April 2010 proposal would change the test that ABS issuers must satisfy to qualify for shelf registration, which currently requires an investment-grade rating.

Two of the proposed new requirements—a 5 percent risk retention requirement and an undertaking to continue reporting—are covered by the Dodd-Frank Act. Before finalizing that part of the April 2010 proposal the staff will develop recommendations designed to harmonize the rules with rules adopted under the Act.

The proposal also would require disclosure of asset level data for ABS. Section 942(b) directs the Commission to require asset level data so the staff is considering this requirement as we prepare recommendations for the Commission.

Other important aspects of the proposal include providing investors more time to consider important information about the particular ABS offering, requiring issuers to file a computer program of the cash flow waterfall provisions, and requiring issuers to undertake to provide information to investors in certain exempt offerings. We are reviewing the comments received on the April 2010 proposal, and as I noted, we will work to harmonize the rules with the ABS rules required by the Dodd-Frank Act.

Thank you for inviting me to appear before you today. I would be happy to answer any questions.

[The prepared statement of Ms. Cross can be found on page 77 of the appendix.]

Chairman GARRETT. I thank you very much.

Mr. Krimminger?

**STATEMENT OF MICHAEL H. KRIMMINGER, GENERAL COUNSEL, FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)**

Mr. KRIMMINGER. Chairman Garrett, Ranking Member Frank, and members of the subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation on the interagency proposal to implement the risk retention requirements of Section 941 of the Dodd-Frank Act. The goal of the inter-

agency proposal is to reestablish a sustainable private securitization market that will once again be an important source of liquidity for affordable credit.

In fashioning new rules for the securitization market, the FDIC and the other agencies seek to incorporate the lessons learned from the financial crisis. The proposed rule implemented in Section 941 addresses a key driver of the financial crisis, the misaligned economic incentives within the securitization process.

Just over 2 weeks ago, the FDIC and the other designated agencies approved for publication a notice of proposed rulemaking to implement Section 941. As specified in the Dodd-Frank Act, the proposal requires, as a general rule, that securitizers retain not less than 5 percent of the credit risk of the securitized assets.

Requiring securitizers to have real skin in the game will align their interests with the interests of investors, encourage better underwriting, and promote long-term sustainable lending. We believe that a strong and vibrant securitization market utilizing a 5 percent risk retention requirement will best promote sustainable market financing.

Under the proposal, securitizers will be able to pick from a number of options to achieve this 5 percent risk exposure. These options reflect existing market practices and are designed to provide a large degree of flexibility to market participants in structuring transactions.

At the same time, the proposal will prevent securitizers from gaming the risk retention requirement by taking all of their profits up front. To prevent this they will be required to hold their upfront profits in a premium capture reserve account which will be used to pay for asset losses before the losses are allocated to the other investors in the transaction. The premium capture reserve account complements risk retention by ensuring that a securitizer's interests remain aligned with the underlying performance and quality of assets.

Section 941 directs the agencies to create an exemption for certain high-quality home mortgages, known as Qualified Residential Mortgages or QRMs. The law requires the agencies to base their standards for QRMs on historical loan performance data.

To meet this requirement, the proposed rule includes underwriting and product features which, from the data available to the agencies, demonstrated a strong record for reducing the risk of default. Those features include verification and documentation of income, past borrower performance, a prudent debt-to-income ratio, elimination of payment shock features, maximum loan-to-value ratios, a minimum downpayment requirement, and mortgage servicing standards. Many of these features were ignored during the housing boom and the consequences were high delinquency rates and declining house prices.

Many people have expressed concern about the impact of the QRM standard on access to affordable mortgages, particularly for low- and moderate-income borrowers. The FDIC shares these concerns.

The FDIC and the other agencies want to strike the right balance in the rule to ensure that low- and moderate-income borrowers have access to affordable mortgage credit. We look forward

to receiving comments on the impact of the QRM standards on these borrowers. We would also welcome comments on whether the unique needs of low- and moderate-income borrowers can be met through FHA programs and downpayment assistance programs.

It is important to note that the QRM standards are designed to facilitate a vibrant and liquid secondary market for non-QRM mortgages. The agencies anticipate that non-QRM mortgages will constitute a substantial majority of all mortgages. This should facilitate a deep and liquid competitive market that makes credit available for non-QRM borrowers at reasonable pricing.

Moreover, because risk retention was already built into most securitizations, the agencies believe any cost increase associated with the new risk retention requirements will be nominal.

Continued turmoil in the housing market caused by inadequate and poor quality servicing underscores the need to make sure that future securitization agreements include incentives for servicers to mitigate losses when loans become distressed. Servicing standards must also provide for a proper alignment of servicing incentives with the interests of investors and must address conflicts of interest.

The servicing standards in the QRM proposal address many of the most significant servicing issues. For example, the servicing standards require that there will be financial incentives for servicers to consider options other than foreclosure when those options preserve homeownership and maximize value for investors.

Thank you again for the opportunity to testify. I will be happy to answer your questions.

[The prepared statement of Mr. Krimminger can be found on page 250 of the appendix.]

Chairman GARRETT. I thank you.

And I think we have time for one more witness and then the votes have been called. I would just advise the rest of the members of the committee that after your testimony we will take a recess, vote on the two bills that we have, and then come right back for the last two.

Ms. Williams?

**STATEMENT OF JULIE WILLIAMS, FIRST SENIOR DEPUTY COMPTROLLER AND CHIEF COUNSEL, OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC)**

Ms. WILLIAMS. Chairman Garrett, Ranking Member Frank, and members of the subcommittee, I appreciate the opportunity to testify on behalf of the Office of the Comptroller of the Currency this afternoon regarding the interagency proposal to implement Section 941 of the Dodd-Frank Act on risk retention in asset-backed securitization.

The agencies' risk retention proposal is designed to carry out the congressional direction in Section 941 that securitizers have, in effect, skin in the game to incent them to exercise diligence regarding the quality of the loans that they securitize. Reflecting that premise, the exemptions from risk retention that are provided by the proposal are conservative and focus on demonstrably high-quality loans.

In order to facilitate robust securitization markets that would include risk retention, the proposal provides flexibility with several options for how the risk retention requirement may be satisfied. We are very cognizant that implementing the statutory risk retention requirements presents complex issues with multiple public policy implications for competition, credit quality, credit access, and credit costs. Achieving the right balance will be very challenging.

For that reason, the OCC has stressed the importance of the comment process to help the agencies get that balance right. My written testimony summarized the terms and features of the proposed rule and highlights three particular issues of note, which I will touch on here.

The first issue concerns the proposed criteria for Qualified Residential Mortgages, QRMs, that are exempt from any risk retention requirements. The agencies have proposed conservative underwriting standards to define QRMs. These standards were developed through evaluation of available historical loan performance data as directed by the statute.

The preamble discusses several possible alternatives to this approach, however. One would be to permit the use of private mortgage insurance for loans with LTVs higher than the 80 percent level specified in the proposed rule.

The due diligence procedures and underwriting standards imposed by private mortgage insurers could be viewed as consistent with the goals of Section 941 to incent careful underwriting of securitized assets. However, to include private mortgage insurance in the QRM criteria, Congress required the agencies to determine that the presence of private mortgage insurance lowers the risk of default, not that it reduces the ultimate amount of loss. Thus, we will be interested in the data that commenters can provide that addresses that point.

The second issue I note is the question of whether the QRM criteria should include mortgage servicing standards. The proposed rule requires inclusion of terms in the mortgage transaction documents under which the creditor commits to have specified servicing policies and procedures designed to mitigate the risk of default. The agencies have included numerous requests for comment about the approach to servicing standards contained in the proposed rule.

We believe there is a need for comprehensive and uniform mortgage servicing standards that apply not just to high-quality securitized loans but to all facets of servicing, from loan closing to payoff or foreclosure. In our view, mortgage servicing standards should apply uniformly to all mortgage servicers and provide the same standards for consumers regardless of whether a mortgage has been securitized.

To further this effort and discussion, the OCC developed a framework for comprehensive mortgage servicing standards. Other agencies have contributed their ideas and there is now under way an interagency effort to develop a set of comprehensive nationally applicable mortgage servicing standards.

The third issue I note is the treatment of Fannie Mae and Freddie Mac and the agencies' proposal to recognize as a permissible form of risk retention the Enterprises' 100 percent guarantee of principal and interest payments on the MBS sponsored by the

Enterprises for such time as the Enterprises are in their current conservatorship. Through this guarantee, the Enterprises effectively retain 100 percent of the credit risk in the transaction.

Treatment of the Enterprises presents a very difficult combination of issues. Imposition of a risk retention requirement under the regulation could produce results that seem contrary to current U.S. Government policies to shrink the assets of the Enterprises and manage the risk. On the other hand, absence of a risk retention requirement contributes to their distinct status.

Congress has begun to consider fundamental questions about that status and the future structure and role of the Enterprises, and the agencies have committed to revisit and change the retention approach for the Enterprises as appropriate when those changes occur. I appreciate the opportunity to appear before the subcommittee this afternoon, and I look forward to addressing your questions. Thank you.

[The prepared statement of Ms. Williams can be found on page 326 of the appendix.]

Chairman GARRETT. Thank you, Ms. Williams.

And Mr. Ryan and Mr. Lawler, we will have to wait for your testimony.

The committee will stand in recess. We will come back right after the second vote, which should be fairly shortly.

[recess]

Chairman GARRETT. The hearing will come back to order. If we can close the two back doors, that would be great.

And we will start where we left off. Now, we just gave you an extra 30 minutes to go over your notes, if you wanted to make any other changes, Mr. Ryan, and—

Mr. RYAN. I am going to change it on the fly here. Don't worry.

Chairman GARRETT. There you go. The gentleman is recognized.

Mr. RYAN. Thank you.

Chairman GARRETT. Thank you.

**STATEMENT OF BOB RYAN, ACTING ASSISTANT SECRETARY FOR HOUSING AND FHA COMMISSIONER, FEDERAL HOUSING ADMINISTRATION (FHA), U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT (HUD)**

Mr. RYAN. Chairman Garrett, Ranking Member Frank, and members of the subcommittee, thank you for the opportunity to testify today. As this committee knows, during the economic crisis, bundling and packaging mortgages to sell on Wall Street not only fed the housing boom but also led to the erosion of lending standards that deepened the housing bust.

In response, the Dodd-Frank Wall Street Reform law required that securitizers and originators have skin in the game, to retain at least 5 percent of the credit risk. That is the goal of this rule.

Today, I am here to speak to the part of the rule, QRM, that seeks to define the safe mortgage which would not be subject to risk retention requirements because the risk of default is low. Getting this definition right is critical. Too wide a definition could impede the rule's ability to build market confidence in securitization; too narrow a definition could significantly raise the cost of mortgage credit and reduce its availability to American families.

As such, with this proposed rule we sought to balance the need for strong, clear underwriting standards and the continuing need to provide sustainable homeownership opportunities for responsible families. Indeed, we only need to look at this economic crisis to understand that good underwriting is absolutely essential—that is, taking into account the borrower's capacity to repay a loan, their credit experience, the value of the property being financed, and the type of mortgage products that they are purchasing. Each of these components is critical to ensuring that responsible borrowers receive sustainable mortgages.

Mark Zandi, of Moody's Analytics, recently did a comparison of subprime loans originated at the height of the housing bubble to 30-year fixed-rates, fully amortizing with full documentation on owner-occupied properties whose borrowers have prime credit scores. He found that subprime loans performed 2 or 3 times worse. Stated income documentation loans performed 3 times worse. And negatively- amortizing ARMs performed 3 to 4 times worse than mortgages with stronger underwriting standards.

And at FHA we stuck to the basics during the housing boom, with 30-year fixed-rates, traditional products, and strong underwriting requirements. At the same time, FHA has a long, successful history of loans with low downpayments.

This is not to suggest that FHA was immune to the pain that this housing crisis caused. This is why we have pressed forward with the most sweeping combination of reforms to credit policy, to risk management, to lender enforcement, to consumer protection in the agency's history.

As stated, the proposed rule is designed to create a class of loans with a lower likelihood of default. Much of the debate has focused on the appropriate LTV ratio. While there is no question that larger downpayment correlates with better loan performance, downpayment alone tell part of the story, as indicated by both Zandi's findings and FHA's experience.

That is why the proposed rule includes, among other things, two alternatives. The first would require a 20 percent downpayment, while the alternative considers a 10 percent downpayment with the inclusion of credit enhancements.

Because the 10 percent alternative in this rule has the potential to minimize risk while enabling a large share of those who would otherwise be unable to access homeownership to do so in a safe and responsible way, we believe it deserves serious consideration and we look forward to those analyses. Toward that end, the proposed rule includes a number of questions. We look forward to receiving feedback on these issues.

Answering these challenging questions will help us to strike the right balance between strong underwriting and ensuring that responsible borrowers have access to affordable products. Determining the appropriate balance is at the heart of our efforts, not only at the FHA and HUD but across the Administration.

Thank you for the opportunity to testify today and I look forward to your questions.

[The prepared statement of Mr. Ryan can be found on page 294 of the appendix.]

Chairman GARRETT. Thank you, Mr. Ryan.

Mr. Lawler, please?

**STATEMENT OF PATRICK J. LAWLER, CHIEF ECONOMIST AND ASSOCIATE DIRECTOR, OFFICE OF POLICY ANALYSIS AND RESEARCH, FEDERAL HOUSING FINANCE AGENCY (FHFA)**

Mr. LAWLER. Thank you very much, Mr. Chairman, Ranking Member Frank, and members of the subcommittee. Thanks for the opportunity to testify on this rule.

I am going to focus on two areas that received a lot of attention by the agencies and have also been the subject of early public commentary: one, the tightness of the underwriting standards for the QRM exemption, especially the required downpayment; and two, the special risk retention rules proposed for Fannie Mae and Freddie Mac.

For the QRM definition, the Act directs the agencies to take into consideration those underwriting and product features that historical loan performance data indicates results in a lower risk of default. We did.

FHFA contributed by examining Fannie Mae and Freddie Mac acquisitions that were originated from 1997 to 2009. The evidence from these data and a host of other sources shows that LTV is one of the best indicators of risk.

We are proposing that the QRM definition include home purchase loans with at least 20 percent downpayment. Lowering that to 10 percent would have increased the share of qualifying Enterprise loans originated in 2009 by just 5 percentage points, from 27 percent to 32 percent.

The additional loans would be much riskier, though. Their serious delinquency rates were consistently 2 to 2½ times higher than the rates for QRM loans. Because these are Enterprise loans, virtually loans of LTVs above 80 percent had mortgage insurance, so allowing higher LTV loans only if they had mortgage insurance would not have improved the results.

Concerns have been raised about the impact this standard would have on the availability or cost of finance for homebuyers who are unable to put 20 percent of the purchase price down. We are going to receive a lot of comments on this and we will consider them carefully.

But I want to be clear that the proposed rule was not designed to prohibit high LTV loans. It is designed to encourage the production of good quality rather than bad quality high LTV loans. The rule could affect interest rates on non-QRM loans, but only to the extent they are not eligible for GSE or Ginnie Mae securities, and only to the extent that the rules retention requirements exceed what securities investors will require anyway.

In evaluating the potential impact of risk retention it is important to distinguish between the effect of existing risk-based pricing and the effects that might be caused by risk retention. Significant differences in rates based on credit risk already exist today.

In considering how much risk retention might add to borrowers' costs, it is well to keep in mind that interest rates on jumbo loans, which do not currently have any serious securitization options, QRM or non-QRM, available—those rates have been about 60 basis points above those on the largest loans available for securitization

through Fannie Mae or Freddie Mac. In effect, that spread is currently the cost of not being able to securitize any portion of those loans. It seems reasonable to anticipate that in a market environment that is receptive to private label securities, the effect of risk retention on mortgage rates would be much smaller than 60 basis points because risk retention would only prevent lenders from securitizing 5 percent of their loans.

Although the Act authorizes the agencies to make exemptions separate and apart from the statutory exemption that applies to Ginnie Mae securities, the NPR does not exempt the Enterprises from the risk retention requirements. Rather, it recognizes that the Enterprises currently retain 100 percent of the credit risk on their guaranteed MBS, which is the maximum possible and far exceed the 5 percent retention required by Section 941. Therefore, the proposed rule would deem the Enterprises' security guarantees to qualify as a satisfactory form of risk retention.

Retention of 5 percent of the securities issued would not result in a greater alignment of Enterprise interests with those of investors, and it would be inconsistent with the Enterprises' agreements with Treasury that require a 10 percent per year wind-down in mortgage assets held for investment. Simply excluding assets held for the purpose of meeting the risk retention rule from calculations to determine whether the Enterprises have met their portfolio reduction requirements would prevent forced sales of other assets or violations of the agreements but it would not address the purpose of these asset reduction provisions that are in the agreements with Treasury.

And the purpose of those was to reduce the interest rate and operational risks associated with these portfolios for the benefit of taxpayers. Nor does it seem likely that requiring the Enterprises to hold 5 percent of their newly issued securities would encourage any private capital to enter the market to any significant degree. The added Enterprise costs would only be a few basis points.

There are more efficient and effective means to reduce the market share of the Enterprises without unnecessarily increasing taxpayer risk. Congress, the Administration, and FHFA have been considering a number of these.

In conservatorship, the Enterprises' underwriting standards have been strengthened and several price increases have helped to better align pricing with risk. FHFA will continue to review further changes along these lines and we hope to continue to work with Congress on evaluating legislative approaches to encourage greater private sector participation.

Thank you, and I would be happy to answer questions.

[The prepared statement of Mr. Lawler can be found on page 263 of the appendix.]

Chairman GARRETT. I thank you, Mr. Lawler.

And I thank the entire panel for their testimony as well. So I will begin with questioning, and maybe I will take it from where Mr. Lawler left off, but I will open this up to the entire panel.

With regard to the QRM, if you have a security that falls outside of the purview of a QRM, then you have to have retained the 5 percent risk. And if you retain the additional 5 percent risk, what has

to happen if you are a company, is then you have to post additional capital.

What you are alluding to here, and Director DeMarco was saying as well, was that if you do that, that is an added cost to a company to retain that capital. Your solution in the proposed rule to do this is that the GSEs do not have to retain that, and the idea here, as I understand what you are saying, is that the fact that it is guaranteed by all of us, the taxpayers, that basically is enough to cover the 5 percent retention or the capital requirement there.

Now, you heard my comments before that we have a problem with that because we see that potentially, it would have the effect of at least pushing some—perhaps, Mr. Lawler will disagree as to the percentage—but it would provide an impediment to the private market coming back into the marketplace. Why? Because if I have to retain 5 percent over here, why should I do that if I know the GSEs don't have to do that? So, it is easier just to still go into the GSEs.

So there is the rub, right? There is the problem with this.

We had the legislation that we talked about—or I talked about earlier in order to try to address that, basically to do what the original congressional intent was, which would say no exemption for it, but I understand the problem here. This is what Mr. DeMarco was also saying, that effectively you could put a burden on the other cross purpose, which is to wind down the portfolios.

I will digress on there for just 10 seconds as—maybe because if the portfolios are this big now and they have to continuously shrink down over a period of time, a segment of that market could be segmented out and said, this is the segment that is going to be ideally for the 5 percent retention requirements. Now, I understand that—I guess, Mr. Lawler, maybe you said this, that may then force a sale of some assets that you don't want to sell right now because the portfolio has to come down, so that is one problem.

So if that is not the solution to it—and I know what you are saying as far as some of the other underwriting criteria that you are already trying to do over there—are there additional solutions to this problem that we haven't thought of, raising other costs, raising G fees, or something else on top of this? Would that be a solution to try to proverbial—set the proverbial level playing field that we are always trying to get to, which we never get to?

I guess I will start with Mr. Lawler, but I would appreciate everyone's two cents on this.

Mr. LAWLER. I definitely think there are alternative means. The risk retention rule is designed to align the interests of investors and originators and securitizers so that they are all concerned about making loans that are too risky since there is skin in the game. The Enterprises already have those interests aligned in that they are taking all of the risks, and we can't improve on that.

But the concern that you have about the private sector getting a chance to move in is a concern that we share. It is not unique to the risk retention rule. If the risk retention rules will add a few basis points of cost the difference in cost for Fannie and Freddie as opposed to private—potential private entrance is much bigger than that.

And to address that, we need to consider some of the other means that I know that you are considering, which include pricing, could include other underwriting standards for Fannie Mae and Freddie Mac, could include loan limits, could include risk sharing. There is quite a wide variety of things we could do that would shrink the GSEs' share over time, so I think we had better address that.

Chairman GARRETT. Okay.

My time is going quickly and I have a bunch more questions on this. Can you just run down the panel?

Mr. RYAN. Let me add, I think this is a very challenging situation. There is no question that there are a couple of purposes. On the risk retention, they do put their security on the balance sheets. You are not changing the credit risk; you are just adding interest rate risk. That doesn't necessarily accomplish the objective.

I think that they are separable. We can address the shrinkage of the GSE footprint. We have said so in the Administration's work plan, housing reform plan. We can certainly go after greater credit enhancement through either the mortgage insurance companies, through other securitization exercises to reduce the exposure to the credit risk that the GSEs have. You do have the loan limits as well to start to get at that.

But it is definitely a complex and challenging issue and that we are, again—I think all of them will be looking forward to comment on.

Ms. WILLIAMS. Mr. Chairman, I think there would be options along the lines of what has been described. The thing that is very tricky here is the unintended consequences of some of the compensating options that might be suggested. So I think you have raised some good questions for us to be thinking about.

Chairman GARRETT. Thank you.

Mr. Krimminger?

Mr. KRIMMINGER. Mr. Chairman, we certainly share some of the concerns that have been expressed. So we primarily, in looking at this from an interagency working group, were seeking, giving the fragility of the housing market, to essentially not try to impair, if you will, the current GSE housing market and just basically leave the situation unchanged to defer to Congress on how Congress would wish to deal with the GSEs going forward. That was the primary motivation.

Chairman GARRETT. Okay. We would just argue that they didn't because we didn't want the exemption there, but—

Ms. CROSS. We at the Commission shared your concerns about the treatment of the GSEs. I would note from the SEC's special mandate here, which is investor protection, there isn't additional investor protection that would come above the 100 percent guarantee from some more risk retention, so from that standpoint, it is—we were fine with this approach but were concerned about the impact of the special treatment.

Chairman GARRETT. Mr. Alvarez?

Mr. ALVAREZ. The Federal Reserve has long had concerns about the GSEs and their place in the market, but the advantages GSEs have in the market I don't think will come from a QRM definition, whether they are in or out of QRM; they come from their special

status, and that is something Congress will have to address and we will revisit and change our rules in accordance to that.

Chairman GARRETT. The gentleman from Massachusetts?

Mr. FRANK. I want to begin by reference to the servicing requirements, because I am all for, and I know there has been an argument that this somehow violates the intent of Congress. And people will argue about the intent of Congress. I would say people have a right, obviously, to vote however they want, but people who consistently vote against a bill are rarely considered the most authoritative interpreters of its intent since they wished it had never been anything.

I don't recall that there was any particular intent in Congress one way or the other. We spent a considerable amount of time on this. I have checked; we didn't discuss the servicing one way or the other.

I do agree, for instance, with the Center for Responsible Lending that the problems with servicing have contributed to the problem and I think it is entirely appropriate to put good servicing standards in here. I think they do help keep the loan from defaulting if done properly, and I hope that this will be done, that servicing standards will be applied everywhere we can, including in ways that will get to the non-banks.

So I am all for including the servicing standards here, and people can be for that or against it, but invoking a nonexistent congressional intent on the issue I don't think makes a great deal of sense.

Second, on the GSEs—and I don't want the GSE issues to overcome the most important question today, which is, is 20 percent too high, and if it is, what is the right number? I would say this to Mr. Lawler, here congressional intent was very clear: We ought to be covered. The only argument I see against it is that it will make it harder for you to reduce the portfolio, and the answer is we can deal with that with exemptions.

I have to say, I did—I think your argument is a little inconsistent when you say on page 9, if we retain the 5 percent this would not address the purpose, which was to reduce the size of the Enterprises' retained portfolios to limit taxpayer risks. Well, you can't tell me that you are already at 100 percent risk on the one hand but that the 5 percent would limit your—would further increase your risk.

It has to be one or the other. If you are already covered, then the 5 percent can't—how does that add to your risk?

Mr. LAWLER. The reference there was to the agreements with the Treasury.

Mr. FRANK. I understand that, but purpose, you said, was—all right. We will ask Treasury to—

Mr. LAWLER. The purpose of—

Mr. FRANK. Let me ask you this: If Treasury said it was okay, would you be all right with it? Is that your problem? We will talk to Treasury—

Mr. LAWLER. We shared the Treasury's interest—

Mr. FRANK. Okay, then don't use them. If you want to independently make the argument, don't hide behind them.

Let me just say that we have had a serious set of issues about Fannie and Freddie. I think we have various views on it.

If Congress acts soon—and I don't know whether we are going to pass 1 bill, or 8 bills, or 16 bills, or 24 bills, or whatever the Majority strategy is—but if we act, you are going to get covered and I—there is a lot of concern about special treatment of Fannie and Freddie. Please give it up.

There is no real harm here. It almost becomes a matter of turf. The SEC thinks it would be a good idea. It can't add to the taxpayer risk if you are already 100 percent at risk.

I would just urge you to go along with the risk retention. It does not seem to me to make a great deal of difference one way or the other. It may be more a matter of the optic, but the optics are important.

But I really want to get to the central issue that we should be getting to here: 20 percent. Let me start with FHA. You had some experiences. Twenty percent is way higher—the FHA objected when we talked about going to 10 percent. I agreed with that.

I know it is different in the FHA. Does 20 percent strike you as the right number? Do you think we could get the same bang for the buck in terms of good loans at 20 percent—at 10 percent or 8 percent?

Mr. RYAN. Congressman, we—

Mr. FRANK. That is a pretty specific question, so focus.

Mr. RYAN. We are concerned about 20 percent and the impact—

Mr. FRANK. It might be too high?

Mr. RYAN. Too high, yes. We are definitely concerned. And we are seeking feedback and comment—

Mr. FRANK. Okay.

Mr. RYAN. —on what are the performance benefits that come with taking it from a 10 percent down to a 20 percent down relative—

Mr. FRANK. I have been skeptical of the homeownership push, and critical of it in some ways, but 20 percent does seem very high.

To what extent are there tradeoffs? I will say this: I am skeptical that private mortgage insurance does it. Private mortgage insurance has its uses; I don't think it is—you are going to look at the history. I don't see that as being a substitute.

And I have run into this problem: We are in some socially sensitive areas here. Delegating to the private mortgage insurance companies the right to decide who gets to buy a house and not seems to me problematic. I want to have tough standards but I worry about that through the delegation.

But let me ask Mr. Alvarez, what is your sense about a tradeoff between a lower downpayment percentage but tougher standards and enforcement of the qualitative standards?

Mr. ALVAREZ. That is actually what most lenders do. They trade off these different standards.

And that is a very intelligent thing to do but it is very sophisticated, it requires judgment, it requires experience in the market that you are dealing with. We didn't feel we were in a good position as regulators here to make those tradeoffs on behalf of—

Mr. FRANK. Can I ask just one more—let me ask, I guess this is the key question we are having: We would all agree, ideally if those qualitative standards were well administered they would be a substitute, you could bring down the downpayment. Is there a

problem—and I guess this is—is there a way for you, the collective regulators, to supervise the qualitative standards? The nice thing about 20 percent is it is a number, or 10 percent, so it is easy; it is yes or no.

I guess the issue would be—and you can't all answer it now—do we have the regulatory capacity to enforce qualitative standards as the way to protect against bad loans as opposed to the simpler number? I guess that is the issue, and I would ask you all to let me know in writing. I don't want to take any more time now.

What would we have to do to develop the capacity to be able to use—we would all agree that if you could do that, it would be better than an unduly high standard, and I would be interested in your views on that.

Thank you, Mr. Chairman, for the time.

Chairman GARRETT. And I thank you.

The gentleman from Arizona?

Mr. SCHWEIKERT. Thank you, Mr. Chairman. Actually, the ranking member sort of sparked part of this thought.

In regards to drafting the QRM, was the goal when you were doing sort of the rulemaking or the writing of the proposal—was it purely looking at the statutory request to do this or was there a look back saying, "Here is what the bond markets are. Here is what the securitizers would be able to buy things. This will be a triple A paper," or was it also looking at the other side saying, "Look here, we are able to see where delinquency rates and defaults would happen?"

What drove the decision-making? Was it on this side of the equation, so it is the default side? Was it the statutory? Where is there a market?

Whomever wants to share?

Ms. WILLIAMS. I can start. We obviously have to start with the language of the statute that has been enacted, but it is against the backdrop of the experience that we have witnessed over the course of the last 5 or 6 years. And so those market factors—the different tradeoffs, the different objectives that the agencies want to accomplish going forward—they are all in the mix of the discussions and that is why I said there is a lot of balancing of a lot of important and complex issues that go into what will finally be adopted by the agency.

Mr. SCHWEIKERT. Mr. Chairman, is it Ms. Williams? And forgive me. I am embarrassed; I am not wearing my glasses so I can't even read those nameplates from here.

But in that case, it might be 10 percent down if I had someone with a very high FICO score or vice-versa. You start to see this scaling. Was that part of the formula, looking at where—if I am looking at the statutory things, I am more concerned about what is my risk of default. Do you end up with a formula design?

Ms. WILLIAMS. The statutory standard specifically refers to historical loan performance data that indicates a lower risk of default, and so there were a variety of factors—I might defer to Pat to talk more about this—that were looked at by the agencies in this process, and some were more telling than others about risk of default.

Mr. SCHWEIKERT. And as you are also speaking, can I throw sort of one other quirky thing, because I often have a concern over here

that if—many of us were passionate about making sure there is liquidity again, the ability to move money back into our mortgage markets but also have good quality paper. If I was saying, these are the mortgages I am going to buy, I would want title insurance built in there as part of my checklist.

I know mortgage insurance, PMI, is on the default side, but yet if I am the bond holder, or on this side the investor, I am probably okay with that even though it may not have helped me on this side of the equation. Am I wrong in what I was looking for?

Mr. LAWLER. I don't think so, if I understood you correctly. We assume that we would—the markets would thrive in both QRM and non-QRM if we made enough loans, made it reasonable and enough good quality loans fit both categories. If you designed the QRM so it covered almost any loan that people would be willing to have anything to do with then those loans that were outside of that area would find it very difficult to find a home, and the rates on those loans would go up a lot more.

Mr. SCHWEIKERT. And I may take one step sideways on you. Okay, QRM loans—back into the definition of what is secure, ultimately, as you put this package—kind of what the QRM loan—is it always 20 percent, or is it someone with 10 percent but happens to have over here mortgage insurance? Is it someone with 10 percent but incredibly high credit quality? What ultimately becomes the matrix to provide as much options and velocity of sales?

Mr. LAWLER. We read the statute to suggest that QRM loans should be especially good loans that didn't need any risk retention, that risk retention should be the norm but here is a group of loans that simply, without knowing anything more about them, would not need risk retention. And so we thought about more complicated classifications of combinations of credit scores and LTVs, for example, and many other—

Mr. SCHWEIKERT. So would you end up looking on something like a mortgage insurance product as being an alternative to the risk retention instead of the definition of the QRM?

Mr. LAWLER. We did look at what the effect of mortgage insurance was. We tried to find data of loans without mortgage insurance but it was hard to find useful data. What we did find is most of the loans with mortgage insurance have high LTVs. Even with mortgage insurance they were a lot riskier.

Mr. SCHWEIKERT. Yes.

Mr. LAWLER. So we kept it down low and we tried to keep the definition simple. It still took a couple hundred pages. We tried to keep this simple so that it would be manageable and that we weren't trying to define all of the good loans, but a simple group of loans that we were confident were good enough that they wouldn't need risk retention.

Mr. SCHWEIKERT. Okay. Thank you.

And thank you, Mr. Chairman. But something is wrong in our life when "simple" is a couple hundred pages.

Chairman GARRETT. It strikes me the same way too, yes.

The gentleman from California for 5 minutes?

Mr. SHERMAN. I am an old tax lawyer. I am here to say simple is a couple hundred pages.

[laughter]

I think I have discovered a new law, which I don't want to take responsibility for, so I am going to call it "Hank Paulson's Law," and that is that no crisis is so dire that those who caused it cannot become its ultimate beneficiaries. And I am interested in how the regulations before us and other regulatory actions will affect the five big banks, the largest financial institutions that were at the heart of this problem in late 2008.

There are two interlocking boards of regulators. One has the responsibility to determine which entities that are too-big-to-fail should be broken up, and so far that regulatory body has decided, "None. They are all our buddies. We love these guys. They like being big." And more important, they have the lowest cost of funds because they are bigger than they have ever been and they are, indeed, too-big-to-fail.

So by not breaking them up, by letting them get big, by living with us through the 2008 process we have already shown the country that they will get bailed out if they are so big they could drag the entire economy down with us. One board of regulators has made sure that they have the lowest cost of funds.

We have regulations before us from this body of regulators that will allow them to parlay that lowest cost of funds into total dominance of real estate finance because we now have definitions of QRMs that are so restricted that the vast bulk of real estate lending will be under the iron grip of those with the lowest cost of funds who, did I mention before, are too-big-to-fail and the ones that caused the crisis to begin with.

And so I would like to address this to Mr. Alvarez. Have you considered the impact of the proposed QRM definitions on smaller banks and financial institutions?

It seems to me the larger banks would have the capacity to make and securitize non-QRM loans while the community banks, with a higher cost of funds, will not be able to do so at a cost-effective and competitive rate. In fact, one of the consequences of a narrow QRM standard might be to force smaller banks to become merely agents or supplicants to the larger institutions whose low cost of funds would allow them to retain any interest.

So have you considered the effect of these rules on the smaller financial institutions and would it be a bad thing if the effect of these rules just made the too-big-to-fail much, much, much bigger than they are now?

Mr. ALVAREZ. We have thought about this. We actually think small banks will be fine under this proposal for a variety of reasons.

Mr. SHERMAN. Can you pull your microphone up again a little closer?

Mr. ALVAREZ. Sorry.

Mr. SHERMAN. Do you know of any small banks who think that way too, or you just think this about them?

Mr. ALVAREZ. We have put our proposal out for comment, so if I am wrong about this, I will certainly hear quite a lot about it.

Mr. SHERMAN. You are hearing about it. I represent quite a number of—

Mr. ALVAREZ. If I could explain how it works, I think with the small banks—first, keep in mind a lot of small banks do mortgages

in their local area and keep those loans on their balance sheets. They are not affected by this at all.

To the extent that they want to securitize, small banks often generate loans that are in the GSE space, so they would be insured by the—

Mr. SHERMAN. But you know the GSE space is about to shrink. The chairman, perhaps, would like to see that more quickly. And so these rules that you are working with have to be designed to deal with not only the world as it is but as the chairman would like it to be.

Mr. ALVAREZ. So that will be your decision and we have committed that—

Mr. SHERMAN. But you didn't draft these rules thinking, "Well, these rules will crush local financial institutions, but only after the chairman gets his way with regard to GSEs."

Mr. ALVAREZ. We have committed that after Congress addresses the GSE issue, we will adjust these rules to take all that into account. We must take the GSEs as they are today. That is the only option that we have.

And so to the extent a small bank is generating loans that can be in the GSE space, they will be as they are today. Also—

Mr. SHERMAN. If I can interrupt, if you were serious about that you would have—and I realize this would lengthen your document, much to the consternation of one of my colleagues—you would already have that in the rules. You would say, once under 40 percent of the loans in this country are FHA or GSE, then we are going to have these rules apply.

But to tell me, "Oh, the small banks have nothing to worry about because the authors of the regulations that will doom them will ride to their rescue just as soon as the GSEs are smaller entities," without that being self-effectuating, with that being just a glint in the eye of those who are currently serving, I—if you get any favorable comments from small banks, please share them with me.

Mr. ALVAREZ. The other two points I would ask you to consider are that the small banks can generate loans that meet the QRM definition, and those that do not meet the QRM definition would be securitized under the same discipline of the 5 percent risk retention that would apply to any other bank. There is no distinction in the requirement between large and small banks.

Mr. SHERMAN. These rules, with their restrictions, are going to drive the small banks out. They know it; the big banks know it; and you regulators would be more savvy if you understood it as well.

I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

And I am very much encouraged by the gentleman's confidence in my ability to get done what I want to do with regard to GSEs.

Mr. Hurt, for 5 minutes?

Mr. HURT. Thank you, Mr. Chairman.

I thank the witnesses for being here.

I wanted to follow up on what Mr. Sherman was talking about. I represent a rural district in south side, Virginia. Of course, small banks, medium-sized banks make up a large part of those who put capital on the street and I think are responsible for the economic

recovery that we are seeing and are a vital part of the future economic recovery that we all want.

And I just wanted to follow up with Mr. Alvarez about, do you believe that this proposed QRM definition will have a negative effect on small banks, and does it favor large banks to their detriment? I would like to see if we could get a direct answer on that question, and then I would like it, if possible, to have Mr. Krimminger maybe address the same question?

And Ms. Williams, if you could also address the question?

Mr. ALVAREZ. As I mentioned to Congressman Sherman, the rules apply equally in all respects to small banks and large banks. There isn't a distinction here or an incorporated advantage to one over the other in how the QRM definition works, how the GSE exception—or framework works, or any other part of the risk retention rules.

We have asked the small banks and others for their comments on this. We are very interested in that. There is a lot in the Dodd-Frank Act that imposes burdens on small banks in that they have to worry about compliance. The idea of compliance is itself a burden on the small banks and we are working to try to ease that compliance burden wherever possible.

But the risk retention requirement itself does not deviate depending on the size of the bank.

Mr. HURT. And do you think that it should, in light of the disadvantages that it may impose upon those smaller entities that cannot absorb the costs of compliance?

Mr. ALVAREZ. I don't think in the risk retention area that an exception for small banks makes sense.

Mr. HURT. Can you say why?

Mr. ALVAREZ. Because they are generating mortgage loans and then the question is, when those are securitized, sold to investors, is there assurance to investors about the quality of the loans? One way that the Congress has chosen to ensure that there is discipline around the quality of the loan is to have the securitizer, who is not the small bank that originated the loan, but the securitizer who is putting the packages together to sell into the market, retains some of the interest in the loans so that they are clear that these loans meet good standards or meet the standards they have disclosed to their investors that they should meet.

In the crisis, the advantage the securitizers had about the quality of the loans gave them an advantage over the investor as they knew what the quality was; the investor did not know what the quality of the loans and the securitizations were. There was nothing to keep the securitizer disciplined about keeping the quality of the loans high because they could—even where they took on risk retention pieces—they were able to lay that off, hedge it or sell it for counterbalances.

That is all taken away by this risk retention proposal, but that is at the securitizer level. I think the originators will still be able to originate as they have.

Mr. HURT. Mr. Chairman, I would like for Mr. Krimminger and Ms. Williams, if they could, to address the same line of questioning.

Mr. KRIMMINGER. Yes, Congressman. I think one of the things that Mr. Alvarez pointed out is really key. The congressional stat-

ute and the rule was really focused on the role of the securitizer, which is the larger bank that aggregates loans from smaller institutions, by and large, and then does the securitization.

Part of the rule, though, does make a specific provision that will help small banks in this marketplace. That part of the rule simply says that in order for the securitizer to pass the risk retention requirement down to the lender or originator, the originator has to have originated 20 percent of the pool of mortgages that is being securitized. Most of the small institutions that are selling loans for aggregation and securitization do not originate 20 percent of an individual pool, so in most cases all of this risk retention will be held at the securitizer level or the larger bank level, not the smaller or community bank.

So in conclusion, we do not think that the risk retention rules disadvantage the smaller institutions because there is that particular provision that will help protect them from having to bear the risk retention that the securitizer should be bearing.

Mr. HURT. Thank you.

Ms. WILLIAMS. I agree with what has been said. The business model of the community banks, their retention and portfolio or their use of the GSEs, put them in a position where they are not advantaged by this proposal, the way it is structured.

Mr. HURT. Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman yields back.

The gentleman from Massachusetts?

Mr. LYNCH. I thank the chairman.

One sort of simple question: With respect to the definition of a Qualified Residential Mortgage, I noticed you have some limitations here regarding the qualifications of the purchaser. I could understand a loan-to-value ratio, the debt-income ratio. On credit history, however, it says here that if any borrower has any current debt due past 30 days or if they had a—any debt obligation more than 60 days past due they are immediately disqualified from qualifying as a QRM.

I am just curious—that would seem to be rather harsh. If someone falls behind on a cable bill or a telephone bill, it might be more reflective of bad bookkeeping or forgetfulness than a lack of creditworthiness. And I am just curious, as a representative of a government that has a current year deficit of $1.65 trillion, I think it might be a little bit hypocritical to say we are going to put a rule down that if you fall more than 60 days behind on a bill, you are not going to be able to get a Qualified Residential Mortgage.

And I am just curious if there is some thinking out there that supports having such a bright line and a rather harsh requirement.

Mr. LAWLER. It was difficult to try and put together a list of—

Mr. LYNCH. I bet.

Mr. LAWLER. —characteristics like that. Normally, underwriters use credit scores. We were uncomfortable with tying our rules to credit scores that are produced by specific private companies.

Mr. LYNCH. Yes. Mr. Lawler, I don't want to spend all my time on this, but I just want to suggest something.

Look, with today's technology we have an abundance of information on every individual borrower. We really have an abundance of knowledge and we might be able to fashion some better line of de-

marcation for judging their creditworthiness than just saying, okay, you went 60 days behind on your cable bill or a hospital bill, that are notorious for going back and forth.

My own hospital, I owe them $8 one month and they owe me $3 the next month and it goes back and forth so I can see how somebody could fall into a trap on that. I am just concerned about that because it is a 2-year penalty. Once you fall behind 60 days, you are disqualified for the next 2 years from qualifying as a Qualified Residential Mortgage.

The other piece I have is I want to go back to risk retention. And while I understand we are going back and forth about the amount of that, I want to talk about the form of that risk retention. I know you have some very clear models out here—the vertical slice where the securitizer retains 5 percent of each tranche right down the line, which is easy to understand and it is reasonable; or the horizontal slice, where the securitizer retains a first-loss position equal to 5 percent of the probable value of all the asset-backed security interests; and the securitization, I can understand that.

But the bottom one here is sort of a catch-all, and it says a representative sample. The securitizer retains a randomly selected pool of assets materially similar—key phrase—to the assets and the asset-backed securities.

I am curious, would materially similar—would that include a synthetic instrument that tracked a real mortgage? So that is not in there. And materially similar—I understand, you know—help me with this.

I think your microphone is off. I am not sure.

Mr. LAWLER. —and then you take—do statistical tests to see that the ones that you pulled out randomly really do reflect generally the characteristics of the broader pool.

Mr. LYNCH. Okay. Would the triple A tranche of property in Maine be materially similar to a tranche of property in Arizona? Is that—

Mr. LAWLER. No, no. So you go—

Mr. LYNCH. Is that laid out somewhere, because I know it is a common term in securities law but this gives light to some variance that I am not exactly comfortable with.

Mr. LAWLER. We gave as much specificity as we thought we had to. It is something we can revisit. But it is meant to be inclusive of relevant risk factors and location is certainly an important risk factor.

Mr. LYNCH. Okay. Are we just going to import the commercial or securities definition of materially similar, and we are going to be good with that, or are we going to try to draft something that is more—

Chairman GARRETT. The gentleman will answer and then your time will be over.

Mr. LAWLER. We did try to draft something that was a little more complicated, again, at the risk of trying to add another 30 pages to the rule. We tried to keep it brief, but it is something we can explore, whether it is adequate.

Mr. LYNCH. All right.

I thank the chairman. Thanks for your indulgence.

Chairman GARRETT. Thank you.

The gentleman from Ohio?

Mr. STIVERS. Thank you, Mr. Chairman.

My first question is for Mr. Lawler. I was looking through your statistics in your analysis that you put together, and it is unclear to me—it looks like you did an analysis with individual criteria and then you did an analysis with all the criteria and removed one at a time. Is that how you performed this?

Mr. LAWLER. Yes.

Mr. STIVERS. So you didn't do some kind of regression analysis of multiple characteristics to see which multiple characteristics work in tandem the best? Because if you had done that, you might be able to tell us a little more effectively. I know you removed loan-to-value individually so you can tell us what it does to both loan—I was just looking at that—what it does to both the loan volume and the delinquencies, but you can't really tell us what the impact of multiple criteria without that one is, or can you? Thank you.

Mr. LAWLER. —held everything at the QRM definitions and just moved that to see what the effect was.

Mr. STIVERS. So obviously the volumes went up slightly—not as much as they would have on the debt-to-income and payment-to-income. The volume of loans actually would have increased the most on those, but the delinquencies also look like they increased a decent amount on those and looks like delinquencies got worse when you removed the FICO scores or some type of, I guess it was FICO scores, and the loan-to-value was somewhere in the middle between those two. Is that about right?

Mr. LAWLER. Yes.

Mr. STIVERS. And the reason I am asking, obviously, is all of us are concerned about access and 20 percent down is a lot of money. What FHA talked about earlier, they have continued to offer loans that have lower percent downpayments and they have not seen as many problems because they had real underwriting criteria, and they didn't take stated income loans, and so they haven't seen the same kind of problems that folks who didn't have real underwriting had.

My grandfather was a banker and he made loans on loan-to-value. My father was a banker; he started making loans on cash flow. And as your analysis shows, cash flow is the best determinant of whether somebody is going to pay their loan or not.

I don't know if you could go back and help us figure out, because I think we all want to try to find the middle ground here on access to the American dream, but maybe some of the folks who did your analysis could go back—and this is helpful data, but really helping us see how much of this could be made up by some other factor. Obviously, all of these loans had mortgage insurance so mortgage insurance doesn't change these numbers. Is that right?

Mr. LAWLER. The high LTV loans—

Mr. STIVERS. Yes, the ones that weren't 20 percent.

Mr. LAWLER. That is right.

Mr. STIVERS. It would be really helpful to me. I think your data is great and it helps us see what we are trying to do here, the way forward, but if you could help us as we are trying to all figure out how to deal with loan-to-value as a constraint to access to home-ownership, we would love your help.

Mr. LAWLER. And we certainly will be considering all the comments and evaluating all the data we can. We don't mean it to be a constraint to access to mortgage credit.

I don't think any of the agencies here think a 90 percent LTV loan is a bad loan, per se. It was simply to try and segregate out what would not need any risk retention at all and the predicate for that is that risk retention would not make loans impossible to get or even extraordinarily more expensive.

Mr. STIVERS. But they would make them more expensive?

Mr. LAWLER. Perhaps a little bit.

Mr. STIVERS. Obviously, they would.

Mr. LAWLER. Not necessarily, because if you tried to put together a security today with non-QRM loans the market would require more than 5 percent risk retention.

Mr. STIVERS. Did any of you look at overcollateralization as an option for the risk retention, that we make other people do overcollateralization of things. Is that an option?

Mr. LAWLER. We were looking at a particular kind of security—asset-backed securities—that don't have overcollateralization—

Mr. STIVERS. No, I understand that. But I am asking if anybody has looked at it as an option.

Mr. LAWLER. Not in this exercise, but it is certainly an important possible funding—method of funding—

Mr. STIVERS. Thank you.

My final question is to the entire panel, and it deals with my concern for many of the other asset-backed securities that have been caught up in this regulation.

Chairman GARRETT. I will let the panel get that answer back to you in writing, if you want to state the question to them.

Mr. STIVERS. Sorry. Thank you. I didn't realize I was out of time. I don't have my glasses on. Sorry, Mr. Chairman.

I yield back my nonexistent time.

Chairman GARRETT. There we go.

The gentlelady is recognized.

Mrs. MALONEY. I want to thank the panelists. It is a very busy time for us with all the budget, and so I was not able to hear all of your questions. But what I am hearing from my constituents, and even Members of Congress, is before the crisis we were over here with very lax standards. The joke in New York was, if you can't pay your rent, go out and buy a house. They didn't require any documents. Nothing.

Now, we have gone over here where it has become very, very difficult to get a loan. And I had two constituents tell me that they required so much paperwork—they required their cancelled checks for 2 years, they required their divorce settlement to review it, they required just—said it took 2 or 3 months just to get the paperwork together to get the loan. And then, of course, many people are questioning the 20 percent down in the draft rule.

So I just would like anyone who would like to comment on, have we gone too far in the other direction? There is a lot of discussion now about the difficulty of getting the housing market moving and we know that the housing, according to Zandi and other economists, is 25 percent of our economy. If we are not going to be gener-

ating a lot of activity in the housing, it is going to be a drag on the economy.

So specifically, I just wanted to know if you think we have swung too far in the other direction, and your draft rule requires a 20 percent downpayment in order for the Qualified Residential Mortgage and exempt from risk retention. Could you give me or describe the research you did regarding what percentage of home purchasers this would preclude comparing to a lower standard of either 10 percent or 5 percent and also describe what research you did regarding the relative difference in loan default and losses from a 20 percent standard compared to, say, a 10 percent or a 5 percent standard, assuming that all other QRM requirements were kept in place?

And I would like to also hear some comments on the contrast between the private sector financing these loans and FHA. Does FHA also have the 10 percent down requirement? And if it doesn't, if they are not equal then you are giving—now it is more difficult to get the private sector back on their feet and—which many people would like to see happening, or maybe they can't. But why is there a difference between an FHA and a private sector QRM downpayment percentage?

And I just open it to anyone and everyone to respond.

Mr. LAWLER. I will start on a couple of items. We looked at what volume of Fannie Mae and Freddie Mac loans would have met the 20 percent downpayment and the other QRM conditions, and for 2009, the latest year we looked at, 27 percent of homebuyers would have met it; for all loans 31 percent would have met it.

This rule would take effect 1 year after it was promulgated. In the meantime, and perhaps after that, depending on what Congress does, we have Fannie Mae and Freddie Mac who buy loans with more than 80 percent down, certainly.

FHA is a very important source of—you talked in the beginning about very tough underwriting standards. FHA has increasingly tough underwriting standards but not nearly as tough as those you described, I would guess, and that is an important outlet for people.

And so there are other sources, and again, when designing this, we didn't mean for non-QRM loans to be unavailable, only that they would require risk retention when used in securities.

Mrs. MALONEY. Would anyone else like to comment?

Mr. RYAN. Congresswoman, I will add that the macroeconomic effects of the various choices on downpayment and the underwriting criteria are an important consideration. We need that input; we need to understand kind of the implications there.

There is no doubt we need to make sure we have tight, strong underwriting guidelines, that we are managing that credit risk, but we absolutely need to make sure that we don't overcorrect. It is a natural tendency, kind of after a large event like that.

We need to go back, and as the colleagues here have done, and we need to continue to look at the data. We need more data about those loans that have had a long history of low downpayments and how they have performed and whether that adequately meets our consideration about the quality underwriting and the performance,

and what are the implications on the volumes of loans that are being eliminated by imposing overly strict underwriting standards?

Dr. HAYWORTH. [presiding.] Would the gentlelady care to submit the remainder of her questions in writing to the panel?

Mrs. MALONEY. Sure.

Dr. HAYWORTH. Thank you.

And the Chair yields herself 5 minutes or however fewer than that may be needed in view of the time constraints we are under.

A question for Mr. Lawler: Was a 10 percent figure—10 percent loan-to-value figure—ever considered when you were working on the downpayment issue?

Mr. LAWLER. Yes, we did. We considered quite a range of possibilities, including 10 percent. We even considered the possibility of having a 5 percent risk retention bucket, a zero, a QRM, and something in between.

And we asked a lot of questions in the rules for comment on those.

Dr. HAYWORTH. Okay.

Mr. LAWLER. And the 10 percent—we observed that the 10 percent downpayment had a lot more defaults associated with it than 20 percent.

Dr. HAYWORTH. So this was a statistical analysis that you optimized at 20 percent, essentially?

Mr. LAWLER. As best we could. There was a big difference between loans that did and did not have 20 percent—

Dr. HAYWORTH. That was where you found a step off, so to speak?

Mr. Alvarez, this question probably is best directed toward you, but for the panel: Title 14 of Dodd-Frank also, of course, has the qualified mortgage safe harbor. Those rules are also being promulgated currently. I realize that rules on QRMs are behind. This clearly is a very challenging issue to resolve on a number of levels.

But will there be any effort to harmonize these definitions?

Mr. ALVAREZ. Yes, absolutely. In fact, the statute requires that the QRM definition not be broader than the qualified mortgage definition. The qualified mortgage definition, of course, is under the Truth in Lending Act. It has a few different kinds of focuses.

We expect that that we will make a proposal about a Q.M. definition shortly and of course it will have to be finalized, so it is on a slightly behind track, but a similar track. And then we will harmonize the two definitions.

Dr. HAYWORTH. Okay. That would seem to be a very important coordination to pursue.

How much more time do you think you are going to need with these rulemakings, just out of curiosity, as the industry waits with bated breath? I am not trying to put you on the spot, but I am just—

Mr. ALVAREZ. No, no. This one is out for comment until the beginning part of June, so we will need at least that much time and then some bit of time afterwards depending on how the comments come through, and how many we get, and what the complexity is. This is a very important rule. We want to make sure we get this right.

We are putting a lot of resources into it. All the agencies have worked very hard on this one. So we are going to try to do the best we can as quickly as we can. We are behind the schedule that Congress set for us but we are going to try to do it as quickly and as well as we can.

Dr. HAYWORTH. Very well. And I appreciate very much your answer, sir, and the participation of the entire panel.

In deference to the need for us to vote, at this time, with thanks, we will dismiss the panel. And as the Chair, I want to note that some of our members may wish to submit questions in writing to the panel and the record will remain open for 30 days in order for members to submit questions to you and to place your responses in the record.

This hearing is now in recess and it will return following votes. The second panel will begin when we return.

And thank you, again, for your time.

[recess]

Chairman GARRETT. Welcome back, everyone.

I appreciate this next panel's forbearance. And so without objection, your written testimony will be made a part of the record, and you will each be recognized for 5 minutes.

Mr. Cunningham is recognized for 5 minutes.

**STATEMENT OF HENRY V. CUNNINGHAM, JR., CMB, PRESIDENT, CUNNINGHAM AND COMPANY, ON BEHALF OF THE MORTGAGE BANKERS ASSOCIATION (MBA)**

Mr. CUNNINGHAM. Thank you, Chairman Garrett.

It is no exaggeration to say that the rule we are examining today will have profound effects on our housing and commercial real estate recovery and determine who can and cannot buy a home for years to come. If finalized in its current form, the result will be much higher costs for the vast majority of consumers and diminished access to credit for many others.

Let me speak first to the most controversial part of the rule, the Qualified Residential Mortgage exemption. Recognizing that loans subject to risk retention would carry higher costs, Congress wisely instructed regulators to exempt safer products from the requirement. While Congress left some of the key decisions to regulators, your intent was clear: to require sound underwriting and proper documentation while excluding nontraditional risky ventures.

Yet, regulators took this authority and opted to exclude most mortgage products, making QRMs the exception instead of the rule. FHFA reports that less than one-third of the loans purchased by Fannie and Freddie in 2009 would have met these requirements. This is all the more notable because 2009 was the most cautiously underwritten market in generations.

Let me bring this home to you. I am an independent mortgage banker operating in North Carolina, hardly the epicenter of the housing crisis.

I ran an analysis on our 2010 book of business, and 58 percent of our purchase loans and 74 percent of our refinance loans would not have met the QRM standards. That is astonishing because 97 percent of that same book of business in 2010 were fixed-rate mortgages.

Mr. Chairman, I have been in the mortgage business for 37 years. During that time, I have found that underwriting is an art, not a science.

No one borrower characteristic will predict whether a loan will default, yet this rule hardwires some of the least flexible underwriting standards any of us has ever seen. The hardest hit would be first-time homebuyers, minorities, and middle class families, for whom the downpayment requirement would be nearly insurmountable.

The ommission of mortgage insurance, which Congress specifically asked regulators to consider, is also troubling. And the debt-to-income ratios may exclude even more qualified borrowers than the downpayment requirement.

The proposal raises several other major concerns. For instance, it is not clear that the regulators reflect a relationship between the QRM and FHA's significantly lower 3.5 percent downpayment requirement.

The Administration's recent GSE White Paper professed a preference for reducing the government's footprint in housing finance and paving the way for a robust private mortgage market. The obvious contradiction between the QRM and FHA's requirement will force more borrowers to seek FHA loans and takes us in the opposite direction.

Another controversial piece of the rule is the national servicing standards. If ever there was a regulatory overreach, this is it. Never in the year-long debate over risk retention were servicing standards proposed or discussed. Congressional intent couldn't have been more clear and directed to origination practices, not servicing.

Moreover, servicing standards are currently being developed through separate regulations and will include requirements well beyond those contained in this rule. Respectfully, this is neither the time nor the place to insert these provisions.

MBA is also concerned that risk retention would apply for the life of the mortgage. Underwriting deficiencies typically emerge shortly after a loan is originated. Any requirements beyond this time will further constrain funds and increase cost to borrowers.

On the commercial side, MBA believes regulators have worked diligently to propose rules that would support a responsible and vibrant CMBS market. However, some elements of the proposed rule, such as the premium capture cash reserve account, are unworkable. MBA will seek clarification and modification to ensure workable rules are in place that will not hamstring the CMBS market.

So where do we go from here, Mr. Chairman? Considering the gravity of the rule, the many concerns it raises, and the nearly 200 questions embedded in it, MBA believes the comment period should be extended to permit a full discussion of the rule's profound implications. We also strongly urge this rulemaking to be synchronized with Dodd-Frank's qualified mortgage safe harbor.

Finally, we urge Congress to call on the regulators to recognize the enormous restraints the risk retention rule would put on homebuyers, especially the steep downpayment and DTI requirements, and to come back with a more flexible approach to underwriting.

We thank you for your interest in this important topic and look forward to answering questions.

[The prepared statement of Mr. Cunningham can be found on page 86 of the appendix.]

Chairman GARRETT. Mr. Deutsch?

**STATEMENT OF TOM DEUTSCH, EXECUTIVE DIRECTOR, AMERICAN SECURITIZATION FORUM (ASF)**

Mr. DEUTSCH. Thank you, Congressman Garrett. My name is Tom Deutsch. I am the executive director of the American Securitization Forum, which represents over 330 member institutions that serve as both issuers, investors, and broker-dealers in the securitization marketplace representing all forms of asset classes in the securitized marketplace, which includes residential mortgages and commercial mortgages as well as auto loans, credit cards, student loans, asset-backed commercial paper, as well as lots of emerging and esoteric asset classes—rail cars, different types of timeshares. There is an extensive array of securitizations that are affected by this rule that are well beyond the mortgage debate that I will discuss in some detail today in my testimony.

We are here today to not only applaud the regulators for parts of their rules, but we are also here to point out many of the areas where they didn't seem to accept many of the comments that we provided in November and December of 2010. We requested a lot more specificity related to these different asset classes, and in particular, I will discuss three key areas in the auto sector, asset-backed commercial paper, as well as the student loan market, before I get back to the mortgage-related issues.

But first, let me be very clear: ASF, our investor, and our issuer members are very supportive of the goals of aligning incentives between issuers and investors. We also support targeted solutions in certain asset classes where better alignment can be made.

But we strongly oppose efforts to try to create unhelpful retention in asset classes that demonstrated very strong performance in the recent credit downturn, and that is where investors in particular don't believe there are any misalignment of incentives in those asset classes.

In particular, I would note that in these other asset classes, in these other areas, would force keeping additional capital on the books both of banks and depository institutions as well as captive auto finance companies, student loan lenders, etc., that are not in the business of retaining capital and credit but are in the business of originating them to be able to provide credit to consumers.

Moreover, FAS 166 and FAS 167 accounting considerations, which can force consolidation of securitizations for risk-based capital purposes—these can lead to absurd results if a bank holds only 5 percent of a first loss position and also services the loan but yet requires them to reserve capital for 100 percent of the risk for the transaction even though they had sold off 95 percent of the risk. So there are important regulatory capital, accounting, and legal considerations that have to be addressed throughout these rules that have not been fully addressed currently.

So let me provide a couple of examples of areas where we found that there are significant rationale where the regulators did not

necessarily get it right in certain asset classes. Let me start with asset-backed commercial paper.

This is a market right now that has $379 billion of outstandings currently. This is a key hub of middle market funding for businesses throughout America—for residential mortgage loans, credit cards, lots of trade receivables, student loans, etc.

The sponsors of these types of vehicles provide credit support vehicles and that create more than—well more than the 5 percent of risk retention that is required by the Act. Investors, in particular, in this asset class strongly believe that issuers' and investors' interests are currently well-aligned in this aspect, yet we were shocked that the regulators didn't propose that these credit support facilities that investors strongly support are not eligible to be a part of the requirement to meet the risk retention rules. This omission must be addressed or substantial middle market funding in this $378 billion asset class will be lost.

Second, prime auto loans: There was an exemption that was created for auto loans within the securitization transaction—within the proposed rules. Unfortunately, those would provide zero relief to this asset class. That is, not a single auto securitization in the history of the securitization market would currently be eligible for that exemption.

It appears as if someone who was a mortgage specialist wrote these rules because they created things like a 20 percent minimum downpayment on a car loan. I am not very sure how many people actually put 20 percent down on a car loan prior to purchasing them.

Finally, on FFELP student loans, which are currently 97 percent government guaranteed, yet they are still required to maintain a 5 percent risk retention by the issuer. It seems very odd to me that—and makes no sense that unless the government is threatening or possibly could ultimately not stand behind their obligations on these student loans why you would have to retain a 5 percent risk retention when there is only 3 percent credit risk associated with these products.

Finally, let me agree with Mr. Cunningham. Many of the areas related to servicing standards should not be included in the proposed rules.

But moreover, let me turn to the premium cash reserve account that will be discussed in many of these rules. Let me make very clear, although we have heard that there are some differences between the regulators on this premium cash reserve account as to the appropriate meaning of it, the way that it is currently written effectively would put the RMBS and the CMBS markets in a deep freezer out on the back porch. It simply would shut down these markets because of the way that these rules are written.

We understand that the regulators believe that they may have miswrote part of those rules, but we look forward to getting clarification and correction of that because otherwise the impacts on the RMBS and the CMBS markets will be significant.

I thank you very much for the time here and look forward to questions.

[The prepared statement of Mr. Deutsch can be found on page 103 of the appendix.]

Chairman GARRETT. And I thank you.

Mr. Hoeffel, please, for 5 minutes?

**STATEMENT OF J. CHRISTOPHER HOEFFEL, MANAGING DIRECTOR, INVESTCORP INTERNATIONAL, INC., ON BEHALF OF THE CRE FINANCE COUNCIL**

Mr. HOEFFEL. I thank you, Chairman Garrett, and members of the subcommittee. My name is Christopher Hoeffel.

I am managing director at Investcorp International and I am here representing the Commercial Real Estate Finance Council. The Council is unique in that it represents all of the constituents in the commercial real estate capital market, including lenders, issuers, investors, and servicers, among others.

Before I highlight some of our concerns about the proposed regulations, I would like to frame what is at stake. There is approximately $7 trillion of commercial real estate in the United States. Prior to the economic crisis, CMBS provided each year as much as 50 percent of debt capital for commercial real estate.

Between now and 2014, more than $1 trillion of commercial real estate loans will mature and will require refinancing. Without CMBS, there is simply not enough capital capacity through traditional portfolio lenders to satisfy this credit demand. It is for that reason that Treasury Secretary Geithner and other policymakers agree that no economic recovery will be successful unless the securitization markets are revived and healthy.

Although CMBS markets have reemerged with approximately $30 billion to $50 billion of new issue expected this year, we are still walking on eggshells. Financial regulatory reform and the implementation of Dodd-Frank could have the effect of shutting down the flow of capital completely and permanently.

The impact of these rules is, understandably, a matter of great concern for property owners and borrowers. We are therefore grateful to have the opportunity to highlight some of the potentially serious issues with the regulations as proposed.

However, at this point we have far more questions than we have answers. Several elements have sparked extensive internal debate.

First, the proposal includes a new concept called a premium capture cash reserve account that, as drafted, appears to eliminate the economic incentives for issuers to securitize loans. At a minimum, the creation of this wholly new requirement will dramatically change deal economics and potentially securitization structures.

Second, for CMBS specifically, we appreciate the regulators creating a special B-piece buyer retention option. In our space the traditional structure has included a B-piece buyer that purchases the first loss bond position, re-underwrites every loan included in the bond pool, and negotiates the right to remove loans from the bond pool that they deem unacceptable.

The proposal would require, however, that an operating advisor participate in any transaction in which the B-piece buyer is also—has special servicing rights for troubled loans, which is generally the case. The servicer would have to consult the advisor prior to making any major loan-related decisions and the advisor would have the unilateral power to replace the servicer if, in the oper-

ating advisor's opinion, the servicer is not meeting its contractual duties.

Recent CMBS transactions have included variations of this type of operating advisor construct and we are pleased to see that the regulators embraced a concept that has evolved in the free market since the liquidity crisis. However, the regulatory proposal would go further than the market has and would vest the operating advisor with a much stronger all-or-nothing servicer replacement power.

Although many CMBS investors are supportive of the inclusion of an operating advisor function there is a concern that the function as proposed under the regulation would both dissuade some B-piece buyers from investing in CMBS altogether, due to insufficient controls over their first loss position, and add a layer of scrutiny that might lead to a "too many cooks in the kitchen" scenario under which loan servicing and decision making are inefficient to the detriment of both investors and borrowers.

A third concern is that the proposal requires permanent retention by either sponsors or B-piece buyers. This type of permanent investment constraint is unprecedented and could severely limit the universe of institutions that could function as retainers. Many of our industry participants have begun to discuss whether it might be advisable to limit the duration to a finite number of years and then limit subsequent buyers of the retained interest to qualified transferees whose attributes could be defined in the regulations.

Fourth, the proposed regulations include a commercial real estate specific retention exemption for loan pools composed exclusively of qualifying commercial real estate loans that satisfy certain underwriting conditions. It does not appear, however, that this exemption, as currently drafted, would bring any benefit, as essentially no commercial real estate loans would satisfy these requirements.

As I hope I have demonstrated, the stakes here are enormous and the questions are many. The regulators have been under pressure to issue the proposal in accordance with the Dodd-Frank stipulated schedule and we are now under a 60-day clock to fully evaluate and respond to these proposals.

Given that the final rules will not be effective until 2013 for commercial real estate, and given that these rules will also be implemented in conjunction with other accounting and regulatory reform, we urge you to consider allowing the regulators to extend the comment period to enable all of us to get these regulations right. We can still keep the final effective dates the same.

If we don't draft the regulations correctly, the consequences would mean significant drying up of capital that could reverse the still fledgling economic recovery. Thank you.

[The prepared statement of Mr. Hoeffel can be found on page 231 of the appendix.]

Chairman GARRETT. And I thank you.

Mr. Schneider, for 5 minutes?

**STATEMENT OF KEVIN SCHNEIDER, PRESIDENT AND CEO, U.S. MORTGAGE INSURANCE OF GENWORTH FINANCIAL, ON BEHALF OF THE MORTGAGE INSURANCE COMPANIES OF AMERICA (MICA)**

Mr. SCHNEIDER. Thank you, Mr. Chairman. I am Kevin Schneider, president of Genworth's mortgage insurance business, and I also represent MICA, the Mortgage Insurance Companies of America. I will focus my remarks today on changes that will take place as a result of the proposed risk retention rule, and specifically the provisions related to Qualified Residential Mortgages, or QRMs.

As the committee knows, the concept of QRMs in Dodd-Frank is intended to accomplish three key objectives: provide market-based incentives to strengthen the underwriting standards; stabilize the housing markets by promoting sound non-government lending; and reboot the mortgage securitization market by creating a robust, liquid QRM mortgage asset class.

Unfortunately, by failing to include low downpayment loans with mortgage insurance, the current QRM proposal misses the mark on what the bipartisan sponsors intended when the offered the QRM exemption. As the sponsors have stated on numerous occasions, they considered, and deliberately rejected, including a minimum downpayment as part of QRMs.

Private mortgage insurance, by definition, provides real risk retention backed by hard capital and has been doing so for over 50 years. Mortgage insurance minimizes defaults and lowers losses when borrowers do get into trouble.

Getting the rule wrong will have a devastating effect on markets, communities, and families. For decades, millions of creditworthy Americans, perhaps including many of the people in this room, have been able to purchase homes with downpayments of as little as 3 percent to 5 percent thanks to private mortgage insurance. Most have never missed a single payment.

But the draft QRM rule effectively says these Americans are no longer a good credit risk. The rule penalizes those with unvarnished credit but only modest savings.

As a consequence, the housing market recovery will continue to stagnate, and let me explain why. Last year, the median price of an existing home was $153,000. If the 20 percent rule was in effect, a first-time homebuyer would need to save $30,600 for a downpayment. It would take a family earning $50,000 annually nearly 11 years to save this amount even in the best of times.

In 2009, half of all homebuyers made a downpayment of less than 20 percent. The 20 percent downpayment requirement could have kept more than 16 million borrowers out of the market or forced them to pay substantially higher mortgage rates.

Even a 10 percent downpayment would have harmed nearly 9 million borrowers. And the data show that there is no good reason to keep these borrowers out of the market for sustainable low downpayment mortgages.

I have provided comparative data for the record which show that loans with mortgage insurance perform better than those without M.I. In fact, with all other characteristics being equal, insured mortgages become delinquent 32 percent less frequently than comparable uninsured loans.

The facts are clear. Quality underwriting drives good loan performance.

Since 1957, the Nation's mortgage insurers have helped 25 million Americans buy or refinance their homes with low downpayment mortgages. The M.I. industry currently has enough private capital to insure $700 billion in new mortgages, enough to support nearly 4 million of new low downpayment loans over the next several years.

Mortgage insurers acknowledge the important role that FHA plays in serving the low downpayment market. However, every day our private capital competes with FHA to serve first-time and low-income homebuyers. Without parity for private mortgage insurers, this proposed rule will shift virtually all low downpayment lending to the FHA, whose market share already has risen from 5 percent of the overall market in 2007 to 20 percent today.

Additional business to the FHA means American taxpayers will continue to bear 100 percent of the risk for all low downpayment loans. By incorporating mortgage insurance into a final QRM rule, we can continue the type of safe low downpayment lending that for decades has allowed millions of Americans to achieve the dream of homeownership.

On behalf of Genworth Financial and the Mortgage Insurance Companies of America, I thank you for the opportunity to testify before this committee.

[The prepared statement of Mr. Schneider can be found on page 298 of the appendix.]

Mr. SCHWEIKERT. [presiding.] Thank you, Mr. Schneider.

Mr. Smith?

**STATEMENT OF BRAM SMITH, EXECUTIVE DIRECTOR, LOAN SYNDICATIONS AND TRADING ASSOCIATION (LSTA)**

Mr. SMITH. Good afternoon, Chairman Schweikert. My name is Bram Smith and I am the executive director of the Loan Syndication and Trading Association, or the LSTA.

The LSTA has more than 300 member firms which consist of all types of participants in the syndicated commercial loan market. These include large and regional U.S. banks, foreign banks, insurance companies, fund managers, and other institutional lenders. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices in the loan market.

The U.S. commercial loan market is critical to the success of American businesses. There are $1.2 trillion of outstanding funded syndicated commercial loans to U.S. companies.

Institutional lenders such as insurance companies, mutual funds, and CLOs provided $500 billion to these syndicated commercial loans. CLOs alone provided $250 billion.

My testimony today will focus on one aspect of commercial loan lending—CLOs. While the LSTA represents the interests of all loan market participants, not just CLOs, we appreciate the opportunity to offer our views on how the recently proposed risk retention rules under the Dodd-Frank Act would impact the CLO market.

Unfortunately, attempting to apply the risk retention rules to CLOs is like trying to fit a square peg into a round hole. They simply do not fit.

The current proposal would have a profoundly negative impact on the formation of CLOs. This could significantly reduce lending to American corporations and impact their ability to expand and create jobs.

Why won't the proposed rules work for CLOs? As the regulators have noted, fundamentally this rule is about reforming the originate-to-distribute model for securitization and realigning the interests in structured finance.

However, CLOs are not originate-to-distribute securitization. CLOs differ from originate-to-distribute securitizations in a number of ways.

First, CLOs are a way for asset managers like Invesco or Eaton Vance to create investment pools of syndicated loans. These independent third party asset managers have a fiduciary responsibility to their investors. They seek out and purchase pieces of individual loans they believe are good investments, just like they would for a mutual fund.

They buy a limited number of corporate loans, each of which is rated and priced daily. They research and analyze them individually.

They then actively manage the portfolio to minimize losses and maximize returns. This is very different from typical ABS, which are static pools with no asset manager.

In addition, the interests of the CLO manager and its investors are already aligned. The CLO manager is not paid an upfront fee. The only money it makes is from successfully managing this portfolio of corporate loans. If the CLO does not perform, the manager is not paid the vast majority of its fee.

It is important also to note that CLOs performed remarkably well through the global financial crisis. CLOs suffered practically no defaults and investors in CLO notes suffered virtually no losses.

The Dodd-Frank Act mandated a Federal Reserve study of risk retention. The study concluded that, "CLOs are different from most asset classes." It recommended that the rule makers consider, among other things, the economics of different asset classes and securitization structures in designing retention requirements.

Unfortunately, by lumping actively managed CLOs together with static originate-to-distribute securitization structures, the proposed rules do not take into account the unique characteristics of CLOs. Indeed, we are faced with a retention structure that threatens the very viability of CLOs. While we appreciate the agencies' efforts to write many risk retention options, for the reasons described in detail in our written testimony none of them is workable for CLOs.

The proposed rule requires retention of 5 percent of the par value of all CLO securities rather than 5 percent of its credit risk. The horizontal first loss retention option is the only one even marginally feasible for CLOs, but the credit risk in this option is approximately 18 times greater than what was required by Dodd-Frank. This level of risk retention is unwarranted and unworkable for CLOs.

Finally, the qualified commercial loan exemption is written so narrowly that even loans to some of the strongest companies in America, such as AT&T, John Deere, and PepsiCo, would not qualify, thereby rendering the exemption unusable.

In conclusion, CLOs are not static originate-to-distribute ABS. Therefore, CLOs do not fit within the spirit of the risk retention provisions of the Dodd-Frank Act and we believe it is appropriate and prudent to expressly exclude them. But if the agencies nevertheless see fit to include CLOs, it is important to consider ways to optimize the alignment of interests without shuttering this important source of financing to U.S. companies.

We appreciate the opportunity to testify and we look forward to working constructively to help produce the best possible final rule. Thank you.

[The prepared statement of Mr. Smith can be found on page 309 of the appendix.]

Mr. SCHWEIKERT. Thank you, Mr. Smith.

Ms. Harnick?

**STATEMENT OF ELLEN HARNICK, SENIOR POLICY COUNSEL, CENTER FOR RESPONSIBLE LENDING (CRL)**

Ms. HARNICK. Good afternoon, Mr. Schweikert.

I will focus my remarks also on the impact of the proposed rule on the market for home mortgages. We agree with the agencies that Qualified Residential Mortgages should consist only of loans that have responsible and sustainable terms and that are underwritten to ensure the borrower's ability to repay based on documented income.

Where we disagree with the agencies is in our strong belief that these high-quality loans should be broadly available to creditworthy families. They should be the loans of choice for most borrowers.

The proposed rule would do exactly the opposite of what we here suggest. It would create a category of responsible mortgages but would make them available only to a small proportion of creditworthy families.

Those lacking sufficient wealth to make a 20 percent downpayment would be excluded. Twenty percent down means $34,000 down for a home at the median sale price nationwide, and $80,000 in places like Staten Island, or Oakland, California, where many working families live.

This would leave out most families, including the majority of the middle class, regardless of whether they currently own or rent. This will take many qualified homebuyers out of the market.

Shrinking the pool of homebuyers would hurt current homeowners whose homes would therefore be harder to sell. So what will these current homeowners do if they can't sell the home?

Will a family whose adjustable rate mortgage is about to have a rate increase be able to refinance the loan? Not easily. The proposed rule requires even larger downpayments for refinanced loans.

Nationwide, more than half of current mortgage holders could not meet these new requirements. The problem is exacerbated by the rule's debt-to-income requirements and a ban on families who are 60 days late on any bills. These restrictions are too rigid and are more restricted than necessary to ensure the family can responsibly sustain homeownership.

All of this, of course, will take an even greater toll on families of color and those with low to moderate incomes who otherwise

could have successfully purchased a modest home. This is bad for our economic recovery and we think contrary to congressional intent.

In codifying the list of criteria to be considered and defined in the QRM, Congress did not include downpayments, an item that was specifically considered. And Congress was wise not to include a downpayment requirement.

While I would not claim that downpayments bear no relationship to default risks, the data show that for loans that are responsibly structured and underwritten, low downpayments are not a substantial driver of default. Certainly, the amount by which large downpayments reduce defaults is too small to justify the large proportion of American families who would be excluded.

Some might say that families excluded from the Qualified Residential Mortgage should get a mortgage that doesn't meet QRM standards. But a key point of these reforms is to make sure that the safest mortgages become the norm. The idea was not to relegate a large part of the population to second-tier credit, nor should FHA become the primary source of credit for American families.

While it helps in this regard that Fannie Mae and Freddie Mac would still be able to securitize loans to families excluded from Qualified Residential Mortgages this does not solve the problem. The proposed rule would put the government's stamp of approval on the idea that loans with less than 20 percent down are substandard.

Bank examiners and lenders will consider non-QRM loans to be less safe and sound. This will make them more expensive and harder to come by.

When lending was done the old-fashioned way lenders stayed with the borrower until the loan was repaid. They had strong incentives to ensure that the borrower could afford the loan, that any features that could produce payment shock were appropriate for the borrower, and to work with the borrower through periods of short-term crisis to avert unnecessary foreclosure.

In this way the underwriting structure and servicing of the loans all minimized the risk of default. These three features should define a Qualified Residential Mortgage, and such mortgages should be available to all creditworthy families.

I am happy to answer your questions.

[The prepared statement of Ms. Harnick can be found on page 208 of the appendix.]

Mr. SCHWEIKERT. Thank you, Ms. Harnick.

Mrs. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman.

And I thank all the witnesses for being here. It has been quite a long day with our votes.

My first question is for Mr. Schneider. Does mortgage insurance reduce the risk of default?

Mr. SCHNEIDER. Yes. As a practical matter, the relevant comparison when you are trying to compare mortgage insurance and how it does against default is mortgage insurance against piggyback loans, which is really the only other alternative to low downpayment loans.

One can think of a piggyback loan literally almost like risk retention because those loans were done in lieu of mortgage insurance for low downpayment lending and those loans were kept on balance sheets. You could also think of mortgage insurance the same way because in mortgage insurance there is a significant loss position taken by the mortgage insurer, so also risk retention.

When you compare the performance of those two, a study was done of the CoreLogic servicer database on over 5 million loans that were originated from 2002 through 2007, really the height of the crisis. Controlling for origination year, documentation, loan purpose, combined loan-to-value, FICO, and geography, when you looked at all those attributes being equal, insured loans compared to those piggyback loans outperformed the piggyback loans consistently.

They became delinquent 32 percent less of the time. When they did become delinquent, they were cured through the support of the servicer and the mortgage insurer 54 percent more often and ultimately defaulted 40 percent less than the piggyback loan, so—

Mrs. BIGGERT. So could you say that the mortgage insurance reduces the severity of loss instead of the actual risk of default?

Mr. SCHNEIDER. No. I would say that it does both.

What I just described was both a reduction in the actual incident of default and—as well as the severity given a loan default. When a loan ultimately does go to claim, the mortgage insurance pays in the first loss position, so unequivocally it reduces the severity of the—

Mrs. BIGGERT. Thank you.

Mr. Cunningham, does the rule proposal maintain or worsen the playing field between the GSEs and the private securitizers?

Mr. CUNNINGHAM. The rule, as it is currently proposed, would allow for those GSEs to be exempt from QRM, so therefore it would, in my opinion, worsen the position of private capital.

Mrs. BIGGERT. Ms. Harnick, do you believe that there should be any downpayment requirement? And if so, how much?

Ms. HARNICK. We believe certainly for mortgage lending there should be some money down, but we don't believe that there should be a requirement set out in the QRM rules. The amount—as I said in my prepared statement, it is not that the size of the downpayment has no relationship to default; it is that the number of families excluded is not justified by the relatively limited amount of default reduction you get when other factors are in place to make sure the loan is responsible.

Mrs. BIGGERT. Why is it that you wouldn't tie it to the QRM?

Ms. HARNICK. The reason I wouldn't tie it to the QRM is that the downpayment requirement really is a wealth-based restriction, and so it is the sort of restriction that should be put in place only if it significantly improves the performance of the loans relative to the people excluded, and it just doesn't do that. And I can say from the lending experience of our sister organization, Self-Help Credit Union, for example, we found that for some families, $500 or $1,000 is enough skin in the game to keep them paying well and for other families, a large downpayment isn't enough to keep them paying well. But the best drivers are these other factors.

Mrs. BIGGERT. Thank you.

Mr. Deutsch, how will the proposed rule impact the smaller banks and financial institutions? Will they have more trouble with or be out of game compared to the larger banks?

Mr. DEUTSCH. I think all the banks will have a much harder time being able to originate loans. I think there will be some disproportionate impact on the smaller banks in particular because private label securitizations will have a more difficult time coming back, as Mr. Krimminger outlined in the previous panel. Having aggregator transactions by reducing the ability for those to get off the ground, there will be less ability for the capital markets to purchase them through the smaller banks and will create more limited capital that they will be able to originate.

Mrs. BIGGERT. Thank you.

My time has expired. I yield back.

Mr. SCHWEIKERT. Thank you, Chairwoman Biggert.

Mr. Manzullo?

Mr. MANZULLO. I would like the record to note that none of the people who voted for this bill are present at this second panel. They should be here to answer to you and so you can give them the reasons why this horrible piece of legislation is going to further stifle credit.

Let me ask a general question here. States such as, I believe, California and possibly Nevada do not have requirements for deficiency judgment. The State of Illinois does, which—you guys are already shaking your heads and you know what the question is.

Do you believe that the States that don't have a deficiency payment, whereby a person can simply walk away from his house and not be slapped with a judgment of the difference between the amount of the note and the sales price, does that increase, in your opinion, the default rates? Does it serve as an incentive not to stick it out and work it out on your house? Anybody?

Mr. DEUTSCH. I will take a first shot at—

Mr. MANZULLO. Yes, sir.

Mr. DEUTSCH. Absolutely. We would be supportive of more recourse back to the borrowers for taking out loans that they ultimately have to pay back. Creating these walk-away borrowers has been a significant problem, I think, for mortgage lenders and institutional investors who purchase mortgage-backed securities.

By not having recourse, a borrower can just sort of simply walk away, turn their keys in, it does create very significant challenge in being able to price the risk, particularly in a housing market downturn.

Mr. MANZULLO. Do you have any idea of the number of States that don't require deficiencies judgments? Anybody?

Kevin, do you have any idea how—

Mr. SCHNEIDER. I don't know offhand what the number is.

Mr. MANZULLO. Okay. Because what is interesting is that the people who took out the loans, who signed the documents in the States where there is no deficiency, are now going to be required to go to a bank, and so if they default, the bank holds the bag but the consumer walks away with no liability. Does anybody think that makes sense?

I thought that you were going to volunteer to give an answer down there?

Ms. HARNICK. I was reaching—it is beyond the topic I was prepared to testify on, but I am just sitting here thinking, in the commercial mortgage space, I haven't heard anyone object to the idea that a borrower on the commercial loan, for example, can go to bankruptcy court and get released on the mortgage, and it is effectively a similar concept. The note holder gets the value of the mortgage—the value of the property in connection with the bankruptcy sales but no more.

Mr. MANZULLO. But so can the homeowner in the States that have a deficiency judgment—bankruptcy.

Ms. HARNICK. That is correct. But I am saying we haven't heard much objection to this in the commercial mortgage space, and for most families, at least in our lending experience, most families do not walk away from the home if they have any way to save it. And so the effort to go after the family for the value of the personal property home and whatever else can be extracted seems a very poor social outcome and probably not financially—

Mr. MANZULLO. It is a financial obligation. If you sign a note for $100,000 and you default on your loan, and the assets sell for $60,000 and you still owe $30,000, to me that is a moral obligation that attaches to that, and sometimes what I have seen taking place here—I haven't been able to go through all the testimony—is that the people who come in here from the government agencies talk about having all new types of loans and new consumer product divisions and new regulations, and yet it wasn't until October 1st of 2009 that the Fed required written documentation of a person's earnings. And it took a year. It took a solid year for the Fed to come out with that regulation.

Maybe I look at this thing too simply, but people were allowed to buy homes who couldn't even make the first payment and they were actually called "liar loans." And I am not even talking about subprime, but there is still a market for subprime where somebody who has a good job and doesn't have a large downpayment can buy a house, and therefore there is another reason for mortgage insurance on it.

But it just amazes me that something that could have been fixed that simply wasn't done. And now they want to have all these rules which would really mess up securitization, especially on the commercial end, with regard to your family.

Mr. SCHWEIKERT. Thank you, Mr. Manzullo.

Mr. Sherman?

Mr. SHERMAN. Mr. Cunningham, what is the Mortgage Bankers Association's view on this 20 percent downpayment requirement? How is that going to affect home prices in a world where the GSEs are playing a diminished role, as so many of my colleagues—well I would say, I guess, colleagues to my left—could be. Sort of creepy that way, isn't it?

Mr. CUNNINGHAM. The mortgage bankers certainly believe that a 20 percent downpayment is too stringent a requirement. We think that it will increase the cost of credit to borrowers, and decrease the availability of credit to borrowers. Ultimately, fewer borrowers would result, and in the end, prices will have a harder time stabilizing.

Mr. SHERMAN. There is a different price elasticity for different products. At my local pizzeria, they don't cut the price if they have fewer buyers that day; they just make fewer pizzas. The amount of housing stock we have in this country could go up but it isn't coming down, and even a 5 percent or 10 percent decline in effective demand from people who can get a mortgage—could see a tremendous decline in price.

Now, I would like to turn to the role of private mortgage insurance, either Mr. Cunningham or Mr. Deutsch. Private mortgage insurers have been shown to mitigate and cure loan deficiencies—or reduce loan deficiencies—because you have a second set of eyes.

But also, the entire concept of retained interest is that we want somebody in the private sector who really knows what is going on to be on the hook. And it occurs to me that mortgage insurers might be just as smart—they are certainly just as private and they are certainly on the hook to the same degree as would a lender who retains an interest.

Shouldn't the downpayment of loans that are—that qualify reflect the private mortgage insurance involved, or should we require just as high a downpayment even if there is private mortgage insurance?

Mr. CUNNINGHAM. I think that a smaller downpayment would be justified with a credit enhancement or private mortgage insurance.

Mr. SHERMAN. And if the purpose of this retained interest is to say somebody in the private sector who understands the loan—may not have made the loan but understands it, because it is my understanding that the securitizer doesn't have to be the entity making the loan; you could have small banks making the loans, selling them and getting a little shafted on the price when they sell them to the big banks who could then retain the interest.

So the law is structured so that somebody in the private sector has to be on the hook and that has to be the securitizer. Securitizer doesn't make you—there is no magic with that. The securitizer, though, is knowledgeable as to the portfolio, has skin in the game, is in the private sector.

Should we simply regard the mortgage insurance company being on the hook as the same as a retained interest by the securitizer? Should we view the entire team of private sector folks involved in securitization and say, looking at the team, are they on the hook?

Mr. CUNNINGHAM. First of all, I don't think that the exemption for Qualified Residential Mortgage loans excluded low downpayment mortgages. It specifically considered it and decided not to exclude low downpayment mortgages but left it up to the regulators for consideration.

Regulators have chosen to come back and require 20 percent downpayment. I think further consideration of lower downpayment mortgages is certainly a worthwhile conversation and I think lower downpayment mortgages—well underwritten, well qualified—

Mr. SHERMAN. Let me try and squeeze in one more question.

Mr. CUNNINGHAM. Yes.

Mr. SHERMAN. Going back to life as we hope to see it again, what percentage of first-time homebuyers are able to come up with 20 percent down, back when you could—say in 2007, 2006, the world we hope to restore?

Mr. CUNNINGHAM. Mr. Schneider may have better information on this than I do, but I think that in 2009, probably of the buyers who purchased in 2009, close to 47 percent or so put down less than 10 percent.

Mr. SHERMAN. Less than 10 percent? So even in 2009, with higher underwriting standards, half of the effective demand is from those who don't even have 10 percent?

Mr. CUNNINGHAM. Remember, when I say that, that includes FHA mortgages in addition—

Mr. SHERMAN. Right.

Mr. CUNNINGHAM. —to conventional mortgages, so it is inclusive.

Mr. SHERMAN. I yield back.

Mr. SCHWEIKERT. And to my friend to the right, actually on that same track as you were actually—great question.

Mr. Scheneider, could you also—because I would like to hear your response to—

Mr. SCHNEIDER. It is dead on, Congressman. I represent the mortgage insurance industry and we believe the congressional intent in the QRM definition was absolutely to include something—credit enhancements such as private mortgage insurance that did provide significant capital to get significant private equity in a first loss position that could be the equivalent of the risk retention that is suggested in the bill.

Private mortgage insurance—you could think about it as an independent set of underwriting standards that provides the appropriate friction in the system to make sure the originator is really kept honest. And when you have your own private capital at risk and you are in a first loss position after the borrower's equity, which is exactly what the private mortgage insurance industry does, we have demonstrated that it does reduce both the incidence and severity of loss for low downpayment lending and can certainly support a much lower level than a 20 percent down requirement as proposed in the bill.

Mr. SHERMAN. May I ask the indulgence of the Chair to ask—

Mr. SCHWEIKERT. Yes. Let me yield you a minute of my time.

Mr. SHERMAN. —one more question, and that is, the risk retention that the big banks plan to have is if they make a $100 loan and it drops in value to $50, the folks retaining the interest are on the hook for 5 percent of that $50 loss—$2.50, if I calculated that correctly. In contrast, if you have private mortgage insurance on a mortgage that was $100 but now it is worth only $50, how much are you on the hook for?

Mr. SCHNEIDER. The private mortgage insurance industry generally provides 25 percent to 30 percent mortgage coverage on the unpaid principal balance of the loan, so it would be 25—

Mr. SHERMAN. So if for some reason—

Mr. SCHNEIDER. —percent riskier—

Mr. SHERMAN. —they lent $100 and it had to go to foreclosure and they only realized $50 you would be on the hook for $25?

Mr. SCHNEIDER. $25—

Mr. SHERMAN. Which is 10 times the risk the big banks would pay with—if they retained a 5 percent—

Mr. SCHNEIDER. That is our loss position.

Mr. SHERMAN. Yes.

I yield back.

Mr. SCHWEIKERT. Thank you. And in many ways, you asked the question I was going to head toward.

I am elated to have you but I also—I have so many questions. Many of you, you don't mind not going home tonight, do you?

[laughter]

Is it pronounced Mr. "Hoeffel?"

Mr. HOEFFEL. "Hoeffel."

Mr. SCHWEIKERT. "Hoeffel." Help me work through the reserve account—the premium reserve account. Mechanically, how do you see that actually working?

Mr. HOEFFEL. The way it has been drafted is that any excess spread that is monetized needs to be retained in the structure of securitization through the term. Now, the reason people aggregate pools of loans and bundle them into securitizations and sell them is clearly they hope to be able to sell the transaction for more than the cost of putting the bundled transaction together, much like having a sandwich shop. You want to sell the sandwich for more than it costs to put the bread and the ingredients together.

But what this is doing is saying any profit you make—because the profit in the securitization generally comes from excess spread—needs to stay in the transaction as additional credit support for the bond.

That might be good for investors but then there is really no reason for the industry to exist because banks and loan aggregators, if they are not going to make any money or even, in this case, in the most extreme case, cover the cost of their personnel and their loan funding—

Mr. SCHWEIKERT. You are beating me, almost, to where I was going. So where would the premium or fee for the securitizing of bringing the debt instrument to market come from?

Mr. HOEFFEL. Where does it come from?

Mr. SCHWEIKERT. If the capture was held aside?

Mr. HOEFFEL. Say you bundle a portfolio of loans that all have an interest rate of 8 percent and then you create a security so that the securities have the benefit of diversification so it is not just one 8 percent loan; it is a portfolio of 300 loans at 8 percent, so you have some credit diversification. The hope is that you would sell the securities for a blended coupon of something less than 8 percent—say it is 7—

Mr. SCHWEIKERT. No, I am very comfortable with the—

Mr. HOEFFEL. In effect, the bondholders are paying you more than par value for the loan because they are paying you a price that yields a lower yield on the sum total of the bonds than the face amount. So you are basically selling for more than the face amount of the bonds, and that is where the excess comes from.

Mr. SCHWEIKERT. But if you have the premium recapture account—

Mr. HOEFFEL. That excess, that 1 percent or 2 percent that is in there stays in the transaction so—

Mr. SCHWEIKERT. So then I will—my question again. So you are putting the package together. How are you paid?

Mr. HOEFFEL. With the premium capture account? You are not paid.

Mr. SCHWEIKERT. Okay. That is sort of where I was sort of heading, the long way around. I am sorry. Maybe I did a very poor job.

In my last 6 or 7 seconds, Mr. Schneider, and maybe I am working on the conceptual problem here because I see us talking about the QRM and then I talk about over here, the 5 percent. In many ways, I think we are having a conversation we are talking around each other.

Okay, qualifying loan over here, the 20 percent, this is the credit quality. It is a nice, safe instrument. But when we talk about PMIs, the mortgage insurance, it is not necessarily about this instrument; it is about my threatened risk to the purchasers on the other end of that instrument.

And so over here, I have my qualifying mortgage, which I wouldn't have to have a reserve account for. But over here, if I had somehow insured the pool—the individuals—I could actually be offering loans with less than 20 percent down but it is not the insurance on that individual loan, in many ways; it is the fact that it is another way to insure it so it is not a risk out to the market.

Is anyone else with me that we may be talking around each other on two different sort of subjects here? Let me see if I am making sense.

QRM—it is just about the individual loan, and we can accept that.

Mr. SCHNEIDER. The underwriting quality of an individual loan.

Mr. SCHWEIKERT. Mortgage insurance comes into effect when it is already in default.

Mr. SCHNEIDER. Mortgage insurance is provided potentially on a loan at the point of origination and the discussion about mortgage insurance vis-a-vis QRMs is, does that allow a lower downpayment—a low downpayment mortgage to qualify as a QRM?

Mr. SCHWEIKERT. In some of the discussion we had in the earlier panel—and I know I am way over my time and I am going to yield myself about another 20 seconds, but in the panel we had before the discussion was, well, we don't want to discuss mortgage insurance because that is after it goes into default we gain the enhanced credit quality and—

Mr. SCHNEIDER. And you reduce the amount of loss associated with this because—

Mr. SCHWEIKERT. Yes, but that happens to be after the loan goes. And the QRM was on this side, saying we are trying to find those loans that won't. And my fear is by creating that type of box we are going to lock out a lot of families from being able to get a home.

Mr. SCHNEIDER. I couldn't agree with you more. By not allowing lower downpayment lending through the support of the credit enhancement the private mortgage insurance provides I think we are dramatically trading off an opportunity to have more creditworthy borrowers be able to participate in the market and help us take some of this inventory off—

Mr. SCHWEIKERT. Forgive me. I am way over my time.

Mrs. Biggert?

Mrs. BIGGERT. It seems like the QRM appears to ignore or dismiss several matrix—full documentation of loans, mortgage insurance, and others—of prudent mortgage underwriting, and in fact QRM seems to set up an arbitrary box of standards for a limited

number of borrowers. And so I have heard from several non-government individuals and groups that the analysis is a mysterious data set that Federal regulators used and it does not reflect other market data on sound mortgage underwriting.

Would you agree with that? And maybe start with Mr. Smith, because I don't think we have heard from you.

Mr. SMITH. I would love to comment but that is not our field. Where we specialize is really on corporate loans and CLOs, so I will defer to my fellow panelists.

Mrs. BIGGERT. Then, I will go to Mr. Schneider.

Mr. SCHNEIDER. Yes, Congresswoman, I would say that as described this morning, in the earlier panel—the comparison that was made on the data analysis was between a below 80 LTV loan and above 80 LTV loan. There is no doubt an above 80 LTV loan is a riskier product.

The discussion needs to be, when you do an above 80 LTV loan is there a way to do it safely? Is there a way to do it that reduces both the incidence and severity of default? And that is what our data has proven and I would like to submit formally for the record a chart I have that we did not submit earlier that illustrates that performance differential that I talked about earlier in my testimony.

Mr. SCHWEIKERT. Okay. Without objection, we would be happy to have it.

Mrs. BIGGERT. Would anyone else like to comment on that?

Mr. DEUTSCH. Yes, if I might address it. I think one of the key aspects of this is if you—if these metrics prove that these loans outside of what the proposed QRM are so unsafe or unwieldy it really begs the question of the statistics that they did include in their release that said only one out of five loans right now that the GSEs—ultimately the American taxpayer—are guaranteeing—only one out of five of those loans would qualify as a QRM right now, which says that the other 80 percent of those loans that the American taxpayer are on the hook for right now are "unsafe or less safe than the QRM."

I think it really begs the question of, why isn't the QRM defined substantially similar to what a current conforming loan looks like that the American taxpayer is on the hook for?

Mr. HOEFFEL. I would say that underwriting mortgages can be very complex, and certainly on the commercial side we have been trying to outline all the different considerations that are made for mortgage loans, so I think it is also similar for residential loans, that using just one or two metrics like LTV can be misleading because you can have a low LTV loan that has bad characteristics or you can have a high LTV loan that has very strong characteristics and they may have vastly different default probability. So it really needs to be a layered analysis on the definition of a high-risk or a low-risk loan.

Mrs. BIGGERT. Okay. And then just one more quick question, if I may.

We are trying, I think, to get less government—get government out of the mortgage finance business and encourage the private sector to replace the taxpayer-backed government financing, so I am concerned that the GSE reform and a narrow QRM more bor-

rowers will try to utilize FHA versus the private sector and then the taxpayer-backed FHA program will be especially attractive if FHA permits a 3.5 percent downpayment. How should Congress address this problem and should FHA serve a more limited role?

Mr. Schneider?

Mr. SCHNEIDER. Congresswoman, I would like to respond to that. As I mentioned and outlined in my testimony, I think one of the things that is very critical right now is there is some form of parity between what is the allowed requirements in the private sector and what is going on in the FHA.

The FHA provides 100 percent coverage on any loans that go into default. That means the taxpayer is on the hook for 100 percent of those loans.

That is the stated intent of the Administration through the White Paper, we are going to start ratcheting that down, and as we think going forward specifically about QRMs and we don't have some type of parity between the private sector and what is allowed in the FHA, you are absolutely right. Business will continue to run to the FHA. The American taxpayer will continue to be on the hook. And private capital will not be allowed to come back into the sector.

Mrs. BIGGERT. Thank you.

Mr. CUNNINGHAM. One of the other considerations is the downpayment. As you pointed out, the disparity between a 20 percent downpayment, as proposed, versus 3.5 percent would obviously push borrowers towards an FHA loan. Making that downpayment requirement less would provide more parity in the marketplace and encourage more private capital.

Mrs. BIGGERT. Thank you.

Ms. HARNICK. I would simply agree that FHA should be serving the pool of borrowers who either are first-time homebuyers or who need help affording reasonable credit, but that in general, borrowers who are creditworthy should be able to go and get mortgages in the first tier of the market. This idea of having two tiers is unhelpful, I think, economically and for the taxpayers.

And I would simply note some of the data that Moody's Analytics has released showing that even 3 percent downpayment loans perform well if properly underwritten and the other respects we have been talking about, that should not be forced to FHA.

Mrs. BIGGERT. Thank you.

I yield back.

Mr. SCHWEIKERT. Thank you, Chairwoman Biggert.

Mr. Sherman?

Mr. SHERMAN. Ms. Harnick, if we had a 20 percent downpayment requirement, what effect would that have on minority homeownership?

Ms. HARNICK. On minority homeowners, the effect would be even more devastating than on white families because most families in America have most of their wealth in their homes. That is just a fact of the way our economy is structured. But for families of color, overwhelmingly the home is the primary place that they build wealth.

And I should say, among, for example, renters, who are largely the pool of available first-time homebuyers, only the wealthiest 25

percent of minority renters have an excess of, I think it is something like $3,000 or $5,000 in cash flow.

Mr. SHERMAN. And I believe that renters in our society in total averaging negative net worth. Is that true?

Either Mr. Cunningham or Mr. Deutsch, if you could explain to me whether—what is the cost of funds of the Big Five banks as compared to everyone else who might retain a 5 percent interest in a mortgage?

Mr. CUNNINGHAM. I think it is fair to say that the cost of funds for the Big Five banks is probably less than it is for smaller community lenders.

Mr. SHERMAN. And as I have editorialized before, the reason for that is—a huge reason for that is the too-big-to-fail syndrome, where we see smaller financial institutions every decade go under and uninsured depositors are—or those with more than the amount covered by FDIC insurance—are out of luck, whereas there is a general perception that if that happened to one of the Big Five, it would be the taxpayers, not the investors. That is why they have a lower cost to fund.

I yield back.

Mr. SCHWEIKERT. Thank you, Mr. Sherman.

Mr. Manzullo?

Mr. MANZULLO. I understand that it is about $1.2 trillion in loans secured by commercial real estate that are going to be coming due within the next 5 years, and that it is a very common practice to take monthly appraisals as the value of these real estate holdings go down then to go to an institution and say, "I would like to refinance," and they say, "Well, you owe more than what this shopping center/commercial building, etc., is worth."

Notwithstanding that minor problem, my concern—and, Mr. Smith, if you could help me on this because from my understanding of CLOs is that you work in a participation agreement with a lender, and based upon your testimony, your CLOs performed extraordinarily well and yet you are being blamed by these rules applying to you when in fact they should not. And so my question—and actually the answer to it appears on pages three and four—but you didn't have the opportunity to give all the testimony—is to explain here why the CLOs performed well and therefore why you should be exempt from risk retention requirements. Do you like that question?

Mr. SMITH. Yes. Thank you.

Mr. MANZULLO. Okay.

Mr. SMITH. And before I start, I was noticing all the questions being focused on mortgages and commercial mortgage so I am glad to have a chance here to talk about this small but extremely vital market, even though it only totals $250 billion.

Mr. MANZULLO. That is a lot of money.

Mr. SMITH. For most people it is, but when you compare it to the securitization market, which is 10 or 12 or however it is defined now we can understand—I can understand, I think, a little bit how the agencies perhaps—I don't want to use the word "overlooked" it, but didn't concentrate on it and figure out the nuances and why it is different.

So as I mentioned before, I would feel very strongly that it is not an originate-to-distribute model, which most of the other securitizations that we have discussed this afternoon are. So why has it performed better?

There are many reasons. Some of the major ones are is what comprises a CLO, and these are corporate senior secured loans that are secured by all the assets or nearly all of the assets in the company. And those loans go through a rigorous process not only by the bank syndicates but by the individual buyers of the loan, the CLOs, in this case; so many eyes get to look on these.

Number two, it is the structure of the CLO which allows and provides for managers to go ahead and individually select these loans on a one-off basis, an independent third party basis. They are paid to do this. They are very similar to asset fund managers and they use all the information that is available.

When I think about what is available out there in terms of transparency, it starts all the way at the beginning. A lot of information about each individual loan provided by the borrower, provided by the banks, provided by the syndicator.

On the other side, what does the investor get? The investor who invests in the CLO—they get a phonebook in terms of volume of information every quarter about each individual loan, how it is performing, what is its price stat, and any other issues that have come up.

And what makes it interesting is that there are only 150 to 250 individual loans in each of these CLOs, so it is very manageable. The CLO manager, who is an investment advisor and covered—and has fiduciary responsibility to his investors, has a lot of other transparencies that help out. These are all rated; these are all priced every day.

There is a vibrant, robust secondary market in secondary loans that he uses for indications of how loans are performing and where the value is. He takes advantage of that secondary market to balance his portfolio, sell some loans perhaps to avoid losses and to buy other loans to maximize returns.

And lastly, and perhaps key, is that the incentives that have been set up in CLOs—the over 630 CLOs that are out there today—align the interests, we think, I think, of the investors with the asset managers.

And so why do I say this? I say this because they get a very small fee—the senior fee—annually to operate and manage these funds. The second fee, the subordinate fee, which can comprise as much as 80 percent—as much as 80 percent of the total annual fee he gets, he only receives that if interest is paid to all the other tranches in the securitization.

And actually, I forgot the most important thing. The CLO manager gets no money when the CLO is closed. He only gets his money on an ongoing basis, an annual fee.

And then there is an extra fee that may or may not occur well down in the life of the CLO—5, 6, or 7 years—more of a profit sharing. If the CLO has generated for the equity holder a return or an amount of money over a certain agreed to level then he gets to share in that.

So we think all the alignments are—make sure that the asset manager is thinking about what the right moves are and to perform well for his investors. So I guess that was a long answer, but I think that—

Mr. MANZULLO. —but I would like to ask, if possible, a follow-up question, because this is really important at this point. Assuming the regulation kicks in, based upon what you have just stated, tell me how that would interweave, or destroy, or the actual impact on the CLO.

Mr. SMITH. Sure. The risk retention, as contemplated now, has five options and none of them really work for CLOs. The one that has been talked about the most is the 5 percent vertical, so I will approach this in two vote—it two facets.

Number one, 5 percent is a lot of money for these CLO managers. Remember, they are not originating this because they are not banks; they are buying. It is very similar to what a mutual fund manager is, and nobody is thinking of asking mutual fund managers to have 5 percent risk retentions on anything they buy. And so 5 percent is a large number.

We have conducted a survey, terminated back in November—only 13 percent of our members said that they could come up with 5 percent on a vertical slice to hold as risk retention. Of those 13 percent, many of them said just because they could probably wouldn't because the return on that 5 percent—because you would be taking 5 percent of the triple A's, 5 percent of the double A's, all the way down to the equity—that wouldn't—they probably wouldn't meet their return hurdles because capital is scarce in all of these companies. So we don't think that will work.

Now, another alternative suggested, and we think it is just mathematically wrong, is take that 5 percent vertical and turn it into a 5 percent horizontal, so you are the first loss. You are the first loss.

And remember, Dodd-Frank says you should take 5 percent of the asset risk here, and this is 5 percent—really taking 5 percent of the entire portfolio and making that the first loss. We don't think any of our members will, if that is the way it goes, will put that money down.

However, we think we can work with the agencies and demonstrate that their proposal is much more excessive than what Dodd-Frank calls for. We have done some calculations. It looks like it could be as much as 18 times as much.

So if there is a first risk position that was much lower than 5 percent that might work for some. My big challenge here is that one of the recommendations that the Federal Reserve study said on risk retention was, what would be the impact on risk retention for all types of managers, so small, medium, and large? We think almost any risk retention will have a detrimental effect on the small—detrimental effect on the small and medium-sized managers. They just don't have the money.

Mr. MANZULLO. I know the hour is late. I do have a quick question of the witness, Ms. Harnick. Would I—

Mr. SCHWEIKERT. I will yield to—actually, this has become sort of an open discussion—

Mr. MANZULLO. I appreciate that.

In your testimony, Ms. Harnick, on page two you state, "Almost 4 years ago our organization released a report warning that the reckless and abusive lending practices in the previous 2 decades would lead to approximately 2 million subprime foreclosures." Now, you don't wear the hat of a prophet, and what was going on back then didn't require a prescient mind, but there were members here going back as far as 2000, when the first GSE reform bill was introduced, that were concerned about it.

It came up again in 2005. In 2005, we had another bill and there was something called the Rice amendment that would have tightened up these lending requirements. And many of us were just really, really upset looking to any agency to step in and say, "You simply cannot keep on lending to people without good proof of their ability to repay."

Tell us what you were saying 4 years ago?

Ms. HARNICK. So first of all, what I wanted to say when I heard you speaking earlier about how it was amazing that it took as long as it did to require documented ability to repay, you would think that would have been a first principle. But I must tell you that we were among the people pushing for that and the resistance was extremely strong from people who said basically, "Lenders know their business. Why do you, Ellen Harnick, think you know what is better for a lender than a lender? They can protect their own interests and if these loans really were risky they wouldn't make them because the market would correct."

What made us in 2006 draw the conclusion we did was that we looked at the structure of the subprime loans and we figured out that they were dependent, really, on ever-appreciating home prices because the loans after 2 years would explode and the borrowers—the lenders were only establishing ability to repay for the first 2 years. And so it was clear that the homebuyer had to refinance before the 2 years were up because they couldn't afford the new payments.

But to accomplish that, they paid a prepayment penalty of something like 300 to 350 basis points, which they could only accomplish by taking a bigger loan in their refinance. And they could, of course, only do that if the home appreciated enough to support the bigger loans.

So what we did then was we looked at the pace of home price appreciation and saw that it was slowing. See, even before home prices began to decline we looked at the pace—the slowing pace of appreciation and just thought, "This simply can't continue." And so we did the math and came up with an estimate that turned out to be unfortunately conservative.

But our real concern all along has been some of the points you yourself have emphasized today. And I will say, the tragedy for us was that for many of the borrowers who got these ridiculous exploding 2/28 ARMs qualified for a 30-year fixed-rate loan at a very small increase on the initial payment, and those people would—many of those people would be in those homes today.

Mr. SCHWEIKERT. Thank you, Mr. Manzullo.

And I appreciate everyone's tolerance. I know we are not paying much attention to the clock but at least we are getting the information and discussion. And with only three of us up here, why not?

Mr. Deutsch, talk to me about what is working right now in the securitization market. Because your organization, you cover all types of securitization. What is working, what is frozen right now?

Mr. DEUTSCH. First, let me say I am jealous of many of my counterparts here on the panel who have one or two asset classes to focus on; I have about six or eight just in my testimony today.

I think what is working normally right now is, for example, auto securitization. At this point, it is my view that we have an absolutely normal functioning auto securitization market.

There is somewhere around $40 billion annually that is being issued. It is certainly down from the peak, but obviously in America right now you are not—Americans aren't buying as many pick-up trucks or cars as they were 2 or 3 years ago because they have a less optimistic perspective.

Mr. SCHWEIKERT. On the consumption of auto securitization, is the securitization market consuming the paper that is available?

Mr. DEUTSCH. There is actually a very high demand right now from the investor community for auto paper. It is, you know—

Mr. SCHWEIKERT. And if these rates go—as you understand them to be, if they were implemented what would that do to that type of securitization?

Mr. DEUTSCH. It would significantly reduce it. And one of the key factors for that is that the originators of most auto loans in America are not banks; they are auto captive, auto finance companies.

They are not necessarily in the business to make loans. They are fundamentally in the business to sell—to make and sell cars and have a captive auto finance company that goes along with it.

Those companies are not built to take risk retention. They are not built to hold capital as part of those captive auto finance companies.

Now, certain of them can and they do as part of those securitizations. They have built this in over the course of the last 20 years in the auto securitization so that they do retain certain amount of risk which is not eligible under these rules.

Mr. SCHWEIKERT. But are they retaining part of that risk as part of their income and their business model?

Mr. DEUTSCH. They are retaining that risk because investors demand it. They say, "I want you to retain some risk and I will buy this securitization." And that market is functioning now—

Mr. SCHWEIKERT. Does securitization sell at a premium because they are holding a risk?

Mr. DEUTSCH. They don't sell at a premium. And fundamentally these investors—if you have $40 billion coming into the market from these institutional investors they are clearly signaling—they think their interests are aligned with those of those who are selling. If those interests are already aligned why add new capital requirement that ultimately will reduce that availability not only for investors to buy but also for consumers to take out those loans?

Mr. SCHWEIKERT. Okay.

Mr. HOEFFEL. If I might, Mr. Schweikert, one thing—one area that is also performing is the commercial mortgage side. We are starting to see a growth in CMBS issuance that has evolved without government intervention. The industry itself has created best

practices, better disclosure. It has brought investors back into the market—

Mr. SCHWEIKERT. Any particular category of underlying asset that is working now?

Mr. HOEFFEL. It is all commercial asset types. They tend to be larger assets in core markets more than in smaller markets. I think that is more a function of just the general economic health of the regions where the properties are located more than from investor appetite.

Mr. SCHWEIKERT. I would yield my time, but why would I start doing that now? And Chairwoman Biggert has been very, very patient with a freshman at the Chair.

Same question, though, on your markets: If these rules went into effect what would that do to the commercial mortgage-backed security market?

Mr. HOEFFEL. Risk retention itself would have some effect on cost, potentially, because we would have to force a 5 percent retention where one doesn't exist now. But we have always had some form of risk retention through the B-piece buyer, so we don't think risk retention in a vacuum would stop the industry, it would just increase the cost of borrowing and create some additional frictional costs.

But with this premium recapture, if that is part of the risk retention regulations that would, as you mentioned—

Mr. SCHWEIKERT. I remember, you and I have been through that one.

Mr. HOEFFEL. Yes.

Mr. SCHWEIKERT. All right. Thank you.

Chairwoman Biggert?

Mrs. BIGGERT. I have no further questions.

Mr. SCHWEIKERT. Anyone else?

I think you may be very blessed to be rid of us. And thank you for also being willing to be so flexible because doing a little more open process at least allowed us—because some of you had some great answers, and just letting it flow instead of cutting you off when the little red light popped up.

Without objection, the following statements will be added to the record: the Education Finance Council; HVP Inc.; and the American Bankers Association.

And the Chair notes that some of the members may have additional questions for the panel which they may wish to submit in writing. Without objection—I wonder if I can object to my own motion—the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

And with that, this hearing is adjourned.

[Whereupon, at 6:20 p.m., the hearing was adjourned.]

# A P P E N D I X

April 14, 2011

For release on delivery
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April 14, 2011

Statement by

Scott G. Alvarez

General Counsel

before the

Subcommittee on Capital Markets

of the

Committee on Financial Services

U.S. House of Representatives

Washington, D.C.

April 14, 2011

Chairman Garrett, Ranking Member Waters, and members of the Subcommittee, thank you for the opportunity to discuss the implementation of the risk retention requirements of section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd–Frank Act). This provision seeks to promote sustainable availability of credit by requiring that securitizers generally retain some of the credit risk of the assets they securitize (sometimes referred to as "skin in the game"). Retaining credit risk creates incentives for securitizers to better monitor the credit quality of assets they securitize and ultimately discourages unsafe and unsound underwriting practices by originators.

In my testimony, I will discuss problems associated with the securitization process that became prominent during the crisis and how the risk retention requirements of the Dodd-Frank Act may help both to alleviate these problems and to provide positive incentives to market participants. I will also describe elements of the rules proposed by the Federal Reserve and other agencies and discuss how these rules can achieve the goals of risk retention without causing undue market disruption or negative effects on the availability of credit to consumers and businesses.

As explained in the Board's October 2010 report to the Congress on the Dodd-Frank Act's risk retention requirements, securitization provides economic benefits that can lower the cost of credit to households and businesses.[1] Securitization can reduce the costs of lending because it creates investment products with different maturity and credit risk profiles from a single pool of assets that can appeal to a broad range of investors. In addition, securitization allows for more efficient management of maturity mismatches. Investors with a long-term investment horizon and stable funding sources can more efficiently hold longer-duration credit

[1] See Report to the Congress on Risk Retention, Board of Governors of the Federal Reserve System, at 8 (October 2010), available at www.federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf (Board Report).

assets because they avoid the asset-liability duration mismatch that often arises with depository institutions (for example, when residential mortgage loans are funded with short-term bank deposits). The ability to match asset and liability duration fosters financial stability. Securitization can also promote financial stability by allowing depository institutions and other lenders a means to reduce concentrations in credit risk to certain types of loans and borrowers on their balance sheets.

However, despite the benefits to the economy, the securitization process is vulnerable to significant informational and incentive problems.[2] Incentives between lenders and investors become misaligned when lenders originate riskier loans in ways that are not readily apparent to investors and quickly sell loans without retaining meaningful exposure to their credit risk. These problems, if unchecked, can lead to inappropriate pricing of risk by market participants and imprudent relaxing of lending standards, which in turn can have severe repercussions and even lead to disruptions in market function. As demonstrated by the recent crisis, the resulting effects can cause serious harm to investors, consumers, financial institutions, and the financial system.

The risk retention requirements of section 941 of the Dodd-Frank Act, in conjunction with other parts of the statute, are intended to help address these problems in the securitization markets. Retaining an economic interest in the credit risk of securitized assets should encourage securitizers to more closely screen and control the credit risk of these assets before securitizing them, and, therefore, should more closely align the interests of securitizers with the interests of investors. Further, this incentive for securitizers to more closely monitor the assets they securitize should act as a check on broad tendencies by lenders to loosen underwriting standards on loans they sell. Importantly, section 941's risk retention requirement applies to all securitizers (regardless of regulatory status) and most types of securitization transactions.

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[2] See Board Report at 14-15.

Establishing the risk retention requirement on a broad basis builds upon the various incentive-alignment mechanisms that have long been a part of the market practice for most types of securitization transactions.

In the months since the Dodd-Frank Act became law, the Board has worked closely with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission (SEC), the Federal Housing Finance Agency (FHFA), and the Department of Housing and Urban Development (collectively, the agencies)[3] to develop proposed rules to implement the risk retention requirements in accordance with the purpose of section 941. We have endeavored to take into account the diversity of assets that are securitized, the variety of structures and practices present in the securitization markets, and the mechanisms for risk retention that have been used effectively in the market, as well as the important goal of fostering the availability of credit to creditworthy borrowers.[4]

The Board welcomes public comment on these proposed rules. This is an important and complex area that directly affects the manner in which liquidity is found to support the availability of credit to consumers, homeowners, small business, and others. The Board looks forward to the information and ideas that will be provided during the public comment period and will consider those comments carefully.

**Proposed Risk Retention Requirement**

In accordance with the Dodd-Frank Act, the proposed rules generally would require that a sponsor of a securitization transaction retain credit risk in the securitized assets either by

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[3] In accordance with the Dodd-Frank Act, the chairperson of the Financial Stability Oversight Council coordinated this rulemaking effort.

[4] The risk retention requirement established by the proposed rules would be a regulatory minimum. The sponsor, originator, or other party to a securitization may, either on its own initiative or in response to the demands of private market participants, retain additional exposure to the credit risk of assets that the sponsor, originator, or other party helps securitize beyond that required by the proposed rules.

retaining 5 percent of the par value of asset-backed securities (ABS) issued in the securitization transaction or 5 percent of the assets securitized in the transaction. The proposal would apply the risk retention requirement to sponsors of securitization transactions, who typically have the most active and direct role in arranging a securitization transaction and selecting the assets to be securitized.

The statute gives the agencies the authority to determine the permissible forms of required risk retention, and its legislative history indicates that the Congress intended that the agencies "recognize the differences in securitization practices for various asset classes."[5] In selecting the permissible options for sponsors to retain risk under the proposed rules, the agencies considered the best practices in risk retention for various classes of assets and their performance during the financial crisis. The options under the proposed rules include:

- A "horizontal interest" in which the sponsor retains a first-loss residual interest in an amount equal to at least 5 percent of the par value of all ABS issued in a securitization transaction. For many asset classes, including auto loans and credit cards, sponsors commonly retain a horizontal interest.
- A "vertical interest" in which the sponsor retains at least 5 percent of each class of ABS issued in a securitization transaction.
- An "L-shaped interest" in which the sponsor retains a combination of vertical and horizontal interests, calibrated to avoid double counting.
- A "seller's interest" for securitizations of revolving lines of credit, in which the sponsor retains at least 5 percent of the unpaid principal balance of all the securitized

[5] See 15 U.S.C. § 78o-11(c)(1)(C)(i); see also S. Rep. No. 111-176, at 130 (2010) ("The Committee [on Banking, Housing, and Urban Affairs] believes that implementation of risk retention obligations should recognize the differences in securitization practices for various asset classes.").

assets. This option is common market practice for securitizations of revolving lines of credit, including credit cards.

- A "representative sample" in which the sponsor retains an interest in randomly selected assets representing in total at least 5 percent of the aggregate unpaid principal balance of all the assets in the pool initially identified for securitization. For example, a sponsor may plan to securitize $100 of auto loans and then retain on its books $5 of whole loans randomly selected from that $100 pool of loans, selling off all of the remaining $95 of loans.[6]

As permitted by section 941 of the Dodd-Frank Act, the proposed rules recognize the standard market practice for commercial mortgage-backed securities (CMBS) transactions, for which risk frequently has been retained by a third-party purchaser (or "B-piece buyer") who negotiates for, and retains, the most subordinated class of interest issued in the securitization. Under the proposed rules, a sponsor of CMBS may meet its risk retention requirements if a B-piece buyer acquires a 5 percent or greater first-loss position that complies with the requirements in the proposed rules for horizontal interests.

**Disclosure Requirements under the Proposed Rules**

As discussed above, some of the problems arising out of the securitization process were due to informational asymmetry among participants in the markets: for example, the sponsor typically understands the risks in the pool better than the investors in the securitization. The proposed rules attempt to remedy some of these asymmetries through disclosure requirements. A sponsor utilizing any of the options to meet its risk retention requirements would be required to provide certain tailored disclosures to investors and, upon request, to the SEC and the

[6] The proposed rules include a variety of policies and procedures, testing, and disclosure requirements designed to ensure the random and representative nature of the sample and limit to the greatest extent possible "cherry picking" of assets by the sponsor.

sponsor's appropriate supervisor (if any). This should provide investors and regulators with useful information on the sponsor's retained interest in the securitization transaction and the basis on which the sponsor valued its interest.

For example, if a sponsor meets its risk retention requirement by retaining a horizontal interest in a securitization transaction, it must disclose both the amount it was required to retain under the proposed rules and the amount it actually retained, in each case, expressed as a percentage and dollar amount. The sponsor must also disclose the material terms related to the interest it retained and the material assumptions and methodology used to determine the aggregate dollar amount of ABS interests issued in the securitization transaction, including those related to the discount rate and estimated cash flows. The other risk retention options generally incorporate these disclosure requirements, and also, in some cases, require additional disclosure related to the specific type of risk retention. Thus, sponsors retaining risk through a representative sample must provide disclosures similar to those required for horizontal retention, and must provide comprehensive disclosures related to the methodologies used to choose the representative sample to ensure that the sample portfolio of assets retained by the sponsor is truly representative of the entire pool of securitized assets.

**Hedging and Transfer Restrictions**

Consistent with section 941 of the Dodd-Frank Act, the proposed rules would prohibit a sponsor from transferring (or pledging as collateral without recourse) any interest or assets that the sponsor is required to retain under the rule to any person other than a consolidated affiliate. The proposal also would prohibit a sponsor or any of its consolidated affiliates from hedging the credit risk the sponsor is required to retain through a financial instrument or agreement that involves payments materially related to that credit risk and that would reduce the sponsor's

exposure to that credit risk. This provision ensures that the sponsor remains exposed to the credit risk of the securitized assets, and, therefore, incentivizes the sponsor to select and manage the securitized assets appropriately, based on quality of underwriting.

Under the proposal, the sponsor and its affiliates would retain the ability to manage risks that are not specific to the credit risk it is required to retain under the proposed rules. Thus, the sponsor may enter into hedges related to market movements, currency exchange rates, home prices, or the overall value of a particular broad category of ABS. These provisions are intended to allow sponsors to continue to appropriately manage their risks on an enterprise-wide basis, while preventing them from evading the risk retention requirements through hedging or transfer of risk.

**Government-Sponsored Enterprises**

The Dodd-Frank Act did not exempt the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac) from their risk retention requirements. Because Fannie Mae and Freddie Mac (the GSEs) fully guarantee the timely payment of principal and interest on the mortgage-backed securities (MBS) they issue and sponsor, they are exposed to all of the credit risk of the mortgages that they securitize. In effect, the GSEs retain 100 percent of the risk of the mortgages they securitize. However, unlike the various other types of risk retention discussed earlier, which all involve the acquisition of an asset by the sponsor, the GSEs' risk exposure is generally in the form of an unfunded guarantee, which would not satisfy the risk retention requirements of the proposed rules.

Nevertheless, there are special circumstances that currently distinguish the GSEs from other securitization sponsors. Both Fannie Mae and Freddie Mac have been operating in conservatorship under FHFA since September 6, 2008. Each of them also benefits from U.S.

government financial support through capital support agreements with the United States Department of the Treasury. These capital support agreements extend to the guarantees made by the GSEs. With the consent of the Treasury, these support agreements may be assigned or transferred to a "bridge GSE" established by FHFA, acting as receiver, with respect to the enterprise (referred to as a "limited-life regulated entity").

In light of these special circumstances, the proposed rules would allow the MBS guarantees of the GSEs to satisfy their risk retention requirements for so long as they (or a successor limited-life regulated entity) operate under the conservatorship or receivership of FHFA with credit support from the United States. The alternative of requiring the GSEs to hold back and fund 5 percent of the MBS they issue would simply expand their portfolios. This would not reduce the burden on the government capital support agreements, and would require the GSEs to issue more corporate debt without having any material effect on the economics of their securitizations or their incentives as sponsors. For the same reasons, both Fannie Mae and Freddie Mac (or a successor limited-life regulated entity) would be exempt from the premium capture cash reserve account requirements and the hedging and transfer restrictions of the proposal.

In recent months, the Administration and the Congress have been considering a variety of proposals to reform the housing finance system, including the operations of the GSEs. The agencies are committed to revisiting and, if appropriate, modifying the risk retention requirements for Fannie Mae and Freddie Mac after the statutory and regulatory framework applicable to them is further developed.

**Allocation to Originator**

Section 941 expressly authorizes the agencies to allow a sponsor to allocate a portion of the credit risk it is required to retain to the originator(s) of the securitized assets, subject to a number of considerations. The proposed rules would permit (but not require) a sponsor of a securitization that is retaining risk through the vertical or horizontal options to allocate 20 percent or more of its risk retention obligation to any originator that contributed at least 20 percent of the underlying assets in the pool, up to the percentage of the securitized assets in the pool that the originator contributed. The originator would be required to hold the risk retention in the same form and manner as the sponsor and would be required to abide by all restrictions of the proposed rules as if it were the sponsor. This provision is designed to allow sponsors to allocate their risk retention requirements only to originators with sufficient financial resources to appropriately monitor the credit risk of all the securitized assets in the transaction and to negotiate the allocation with the sponsor.

**Premium Capture Cash Reserve Account**

In addition to incorporating some of the risk retention practices that were most effective prior to and during the crisis, the proposed rules also attempt to address several practices that tend to undermine the incentives of effective risk retention.

One such practice involves monetization of so-called "excess spread," or "premium capture." In broad terms, the difference between the rate lenders charge borrowers and their total costs is "excess spread." Prior to the financial crisis, securitization sponsors commonly sold off part of this excess spread to realize an immediate profit on the securitization of the assets. While securitization sponsors benefited from this practice, it meant that the excess spread was unavailable to support the ABS tranches bought by investors. More importantly, this practice encouraged aggressive underwriting, allowed the securitizer to offset immediately its retained

risk, and provided incentives for sponsors to maximize securitization scale and complexity in securitization structures.

The proposed rules seek to address this problem by requiring the sponsor to place any amounts it receives from monetizing excess spread into a cash reserve account that would be used to cover losses on a first-loss basis. This amount would be in addition to the sponsor's base risk retention requirement. This regulatory mechanism essentially puts sponsors in a position closer to that of a lender that keeps loans it originates on its balance sheet for the life of the loan. The goal is to promote simpler securitization structures, as sponsors would receive excess spread over time, and to better align the interests of sponsors and investors by promoting more robust monitoring of the credit risk of the securitized assets.

**Exemptions from Risk Retention Requirements**

In circumstances where securitized assets pose low credit risk because they meet high underwriting and other standards set by the agencies, section 941 of the Dodd-Frank Act provides or permits an exemption to the risk retention requirements. The agencies have incorporated these exemptions into the proposed rules, along with other exemptions and adjustments to the risk retention requirements proposed in accordance with the authority granted under the statute.

**Qualified Residential Mortgages**

Section 941 of the Dodd-Frank Act provides that securitizations backed by mortgages that meet the definition of a "qualified residential mortgage" (QRM) are not subject to the risk retention requirements. Under the statute, the agencies must develop a definition for QRM that takes into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default. In addition, section 941 requires that the definition of a

QRM be no broader than the definition of a "qualified mortgage" under the Truth in Lending Act (TILA), as amended by the Dodd-Frank Act.[7] The complete statutory exemption from the risk retention requirements for QRMs based on their low risk of default underscores that these assets must be of high credit quality.

In developing the QRM definition, the agencies examined data from market sources, Fannie Mae and Freddie Mac, the Board's Survey of Consumer Finances, and other data linking mortgage loan characteristics to default rates. The agencies used the data available to them to develop minimum QRM standards that have low credit risk even in stressful economic environments. To be eligible as a QRM under the proposed rules, a mortgage loan must be a closed-end first-lien mortgage to purchase or refinance a one-to-four family property. It cannot have product features that have been associated with a high incidence of delinquencies and foreclosures, such as negative amortization, interest-only payments, and the potential for large interest rate increases. In addition, it must meet standards the agencies have identified as being closely associated with a lower probability of default. These standards include conservative debt-to-income ratios and strict limits on the number of derogatory factors in the borrower's recent credit history. To enhance predictability for participants in the mortgage securitization market, under the proposed rules, QRM eligibility is determined at or prior to origination of the mortgage loan.[8]

QRM eligibility also requires a 20 percent down payment and a maximum loan-to-value (LTV) ratio of 80 percent for purchase mortgages (with no junior lien known to exist at closing)

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[7] The rulewriting effort to implement Dodd-Frank Act changes to the definition of "qualified mortgage" under TILA is ongoing. The agencies will review the "qualified mortgage" rules, when issued, to determine whether changes to the definition of a QRM are necessary or appropriate to ensure that the definition of a QRM is *no broader* than the definition of a "qualified mortgage."

[8] The rule provides for certification requirements to ensure processes are in place to credibly check QRM eligibility at closing. However, if due to an oversight a mortgage loan is later determined to not have met the QRM eligibility requirements, the sponsor would be required to repurchase the loan from the securitization vehicle at a price at least equal to the remaining principal balance and accrued interest.

and a maximum LTV ratio of 75 percent on rate and term refinance loans and 70 percent for cash-out refinance loans. These LTV requirements are supported by the data reviewed by the agencies, which demonstrate that default rates increase noticeably among purchase loans with an LTV ratio greater than 80 percent and are also higher for refinance mortgages.

The Board recognizes that loans with LTV ratios above 80 percent and with other features that do not meet the proposed QRM definition can be safely underwritten. Indeed, the Board anticipates that a somewhat narrow definition of QRM will help ensure that a deep and liquid market for non-QRMs can and will exist. Risk retention in these cases should, in principle, add only modestly to the cost of a non-QRM mortgage. On the other hand, a broad definition of QRM that encompassed a much wider swath of residential mortgages, as some have proposed, could keep the small segment of the market left outside such a QRM definition from being able to attract sufficient funding to thrive. This result could diminish access to credit for creditworthy borrowers and stifle innovation in residential mortgage products that do not meet the definition of QRM. This disincentive is removed if the markets recognize that a great many creditworthy loans may be made and securitized with the retention of a modest amount of credit risk.

In a related matter, some expressed concern that the proposed rules do not expressly incorporate private mortgage insurance (PMI) into the QRM definition. While PMI and similar credit enhancements protect lenders and investors from losses when borrowers default, the agencies have not identified studies or historical loan performance data that adequately demonstrate that PMI lowers the probability that a borrower will default. Moreover, PMI is used overwhelmingly in connection with loans guaranteed by Fannie Mae and Freddie Mac. In fact, these GSEs guarantee approximately 90 percent of loans covered by PMI. As I discussed earlier,

the guarantee provided by the GSEs would satisfy the risk retention requirements under the proposed rules. In the notice of proposed rulemaking, the agencies requested comment on this point and will consider any new data or evidence presented.

A final noteworthy feature of the proposed QRM definition is that it requires the originator of a QRM to incorporate into the mortgage-transaction documents certain features related to servicing policies and practices that would be employed by the loan servicer in the event of a serious delinquency or default on the mortgage. These features include reliance on the net present value calculations in comparing the costs of loan modifications to loan foreclosure, policies for addressing second liens held by the servicer on properties backing a first mortgage held by the securitization vehicle, and certain incentive compensation limitations.

While the proposed rules would apply these standards to the limited group of residential mortgages that meet the QRM definition, the Board is currently engaged in an interagency effort to develop national mortgage servicing standards that would apply more broadly to residential mortgages regardless of whether the mortgages are QRMs or are securitized. These more comprehensive standards would address many of the issues arising out of servicing practices that have affected the residential mortgage market in the past.

**Exemption for Certain Commercial, Commercial Real Estate, and Automobile Loans**

The Dodd-Frank Act directs the agencies to lower risk retention requirements below 5 percent for securitizations of commercial loans, commercial real estate (CRE) loans, and automobile loans, if the loans meet underwriting standards that indicate low credit risk. The agencies developed and are seeking public comment on underwriting standards for these loans categories. Sponsors of securitizations collateralized by loans meeting these underwriting standards would have a zero percent risk retention requirement.

**Other Exemptions**

Section 941 directs the agencies to provide exemptions from the risk retention requirements for certain assets insured or guaranteed by the United States or a U.S. agency. This exemption includes loans insured by the Federal Housing Administration or the Department of Veterans Affairs. The statute also provides exemptions for ABS guaranteed by the United States or a U.S. agency and ABS issued or guaranteed by U.S. state and local governments. The proposed rules implement these exemptions. The proposed rules also provide a safe harbor for certain foreign transactions, based on the limited nature of the transactions' connections with the United States and U.S. investors.

**Conclusion**

The Board, in cooperation with the other agencies, has put significant effort into developing proposed rules that would implement the risk retention requirements of the Dodd-Frank Act. We have attempted to do this in a flexible fashion with the goal of better aligning interests among participants in the securitization markets while preserving the public benefits of securitization, including lower funding costs and increased credit availability for businesses and consumers. The Board welcomes input from the public and from members of the Committee in this effort. I appreciate the opportunity to describe the proposed rules and am happy to answer any questions.

**Testimony on Understanding the Implications and Consequences of the Proposed Rule on Risk Retention**

**by Meredith Cross**
*Director, Division of Corporation Finance*
*U.S. Securities and Exchange Commission*

**Before the Subcommittee on Capital Markets and Government Sponsored Enterprises of the United States House of Representatives Committee on Financial Services**

**Thursday, April 14, 2011**

Chairman Garrett, Ranking Member Waters, and members of the Subcommittee:

My name is Meredith Cross, and I am the Director of the Division of Corporation Finance at the U.S. Securities and Exchange Commission. I am pleased to testify on behalf of the Commission today on the topic of risk retention in securitizations. I appreciate the opportunity to discuss with you the Commission's work in this area.

**Background**

Securitization generally is a financing technique in which financial assets, in many cases illiquid, are pooled and converted into instruments that are offered and sold in the capital markets as securities. The securities sold through these types of vehicles are called asset-backed securities, or ABS. This financing technique makes it easier for lenders to exchange payment streams coming from the loans for cash. Some of the types of assets that are financed through securitization include residential and commercial mortgages, agricultural equipment leases, automobile loans and leases, student loans and credit card receivables. Often, a bundle of loans is divided into separate securities with different levels of risks and returns. Payments on the loans typically are distributed to the holders of the lower-risk, lower-interest securities first, and then to the holders of the higher-risk securities.

The financial crisis focused attention on the possible misalignment of incentives of participants in the securitization process. Risk retention requirements have been discussed by some market participants as one potential way to improve the quality of asset-backed securities by better aligning the incentives of the sponsors and originators of the pool assets with investors' incentives.

**Credit Risk Retention under Section 941(b) of the Dodd-Frank Act**

Section 941(b) of Subtitle D of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act, or Act), which is codified as new Section 15G of the Securities Exchange Act of 1934, generally requires the Commission, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and, in the case of the securitization of any "residential mortgage asset," the Federal Housing Finance Agency and Department of Housing and Urban Development, to jointly prescribe regulations that require a securitizer to retain not less than five percent of the credit risk of any asset that the securitizer – through the issuance of an asset-backed security – transfers, sells, or conveys to a third party.[1] Section 15G also provides that the jointly prescribed regulations must prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain.[2]

On March 30, 2011, the Commission joined its fellow regulators in issuing for public comment proposed rules to implement the risk retention requirements of Section

[1] *See* § 78o-11(b)(1) and (2).

[2] *See* § 78o-11(c)(1)(A).

15G.[3] Consistent with the Act, the proposed rules generally would require a sponsor to retain an economic interest equal to at least five percent of the credit risk of the assets collateralizing an issuance of ABS. In developing the proposal, the staffs of the agencies considered the diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which sponsors have historically retained credit risk exposure.

The proposed rules would permit a sponsor to choose from a menu of risk retention options. These options, and the other conditions of the proposal, were designed to provide appropriate flexibility, while also ensuring that the sponsors actually retain risks designed to align incentives. The four options that would generally be available in all securitizations include:

1) A "vertical slice" option whereby the sponsor retains not less than five percent of each class of ABS interests issued in the securitization;

2) A "horizontal slice" option whereby the sponsor retains a first-loss, last-pay residual interest in an amount equal to not less than five percent of the par value of all ABS interests in the securitization. As an alternative to actually retaining a residual interest, this option also allows the sponsor to establish a cash reserve account valued in the same amount and structured to operate as a first-loss position;

3) An "L-shaped" option whereby the sponsor holds half of the five percent retained interest using the vertical slice option and half in the form of the horizontal slice option; and

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[3] *See* Release No. 34-64148, *Credit Risk Retention* (March 30, 2011), http://www.sec.gov/rules/proposed/2011/33-64148.pdf.

4) A representative sample option whereby the sponsor retains a randomly-selected, representative sample of the assets designated for securitization in an amount equal to not less than five percent of the unpaid principal balance of all the designated assets.

The proposed rules also include three transaction-specific options related to securitizations involving revolving asset master trusts, asset-backed commercial paper conduits, and commercial mortgage-backed securities. These options were specifically designed to take into account the unique structures historically used in these particular asset classes.

In addition to the risk retention a sponsor would be required to retain under the previously described menu of options, the proposal would also require a sponsor to establish a cash reserve account if the sponsor monetizes excess spread in the transaction by selling an excess spread tranche to a third party, or if the sponsor includes an excess spread tranche senior to other ABS tranches in the contractual cash flow ("waterfall") provisions. Excess spread is generally the difference between the yield on the pool of securitized assets and the coupon paid on the securities, servicing costs, and other trust expenses. The purpose of this additional requirement is to prevent sponsors from effectively negating or reducing the economic exposure they would otherwise be required to retain under the proposed rules.

The proposal would also permit the 100% guarantee of principal and interest provided by Fannie Mae or Freddie Mac to satisfy their risk retention obligations for the mortgage-backed securities they sponsor, but only for the period in which these

organizations are operating under conservatorship or receivership with capital support from the United States.

As required by the Act, the proposal provides a complete exemption from the risk retention requirements for ABS that are collateralized solely by "qualified residential mortgages" (or QRMs). The statute requires that the agencies write the definition of QRM "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default."[4] In developing the proposed definition of a QRM, the staffs of the agencies carefully considered the terms and purposes of Section 15G, public input, and the potential impact of a broad or narrow definition of QRM on the housing and housing finance markets.

Similar to the qualified residential mortgage exemption, the proposal also would not require a sponsor to retain any portion of the credit risk in the securitization if the ABS are collateralized by certain high quality commercial loans, commercial mortgages, or automobile loans that meet underwriting standards prescribed by the Federal banking agencies. While only the Federal banking agencies are responsible for prescribing these additional underwriting standards, the Commission is jointly authorized with its fellow regulators to establish the appropriate level of risk retention applicable to the securitization of loans meeting these prescribed underwriting standards.

The proposal would also implement Section 15G of the Exchange Act by exempting from the risk retention requirements certain other securitizations—for example, those backed by government-insured or guaranteed assets, such as ABS guaranteed by the Government National Mortgage Association (Ginnie Mae), as well as certain residential loan programs offered by the Federal Housing Administration,

[4] *See* § 78o-11(e)(4).

Department of Veterans Administration, and Farm Credit Administration. There is also an exemption provided in the proposal for most municipal ABS.

The proposal is the product of many months of collaboration and cooperation among cross-disciplinary teams at the Commission and together with staffs from the five other agencies involved in this joint rulemaking effort. Because of the complexity of the issues involved in this rulemaking, the agencies have included a significant number of requests for public comment in the proposal, and we look forward to analyzing the public's comment. In this regard, interested parties are encouraged to submit written comments jointly to all of the agencies by June 10, 2011.

**Other ABS Provisions in Dodd-Frank**

Other provisions of the Dodd-Frank Act require Commission rulemaking for ABS. Section 943 of the Dodd-Frank Act requires the Commission to adopt rules on the use of representations and warranties in the market for ABS. In January, the Commission adopted final rules[5] to implement this requirement that require securitizers to disclose the history of repurchase requests received for assets that are believed to have violated representations and warranties and repurchases made relating to their outstanding ABS. Securitizers will be required to make their initial filing on February 14, 2012, disclosing the repurchase history for the three years ending December 31, 2011.

Section 945 requires the Commission to issue rules requiring an asset-backed issuer in a Securities Act registered transaction to perform a review of the assets underlying the ABS and disclose the nature of such review. In January, the Commission

[5] *See* Release No. 33-9175, *Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (January 20, 2011), http://www.sec.gov/rules/final/2011/33-9175.pdf.

adopted final rules to implement Section 945.[6] Under the final rules, the type of review conducted may vary, but at a minimum must be designed and effected to provide reasonable assurance that the prospectus disclosure about the assets is accurate in all material respects. The final rule provides a phase-in period to allow market participants to adjust their practices to comply with the new requirements.

Section 942(a) of the Dodd-Frank Act eliminated the automatic suspension of the duty to file reports under Section 15(d) of the Exchange Act for ABS issuers and granted the Commission authority to issue rules providing for the suspension or termination of this duty to file reports. The Commission has proposed rules in connection with this provision of the Act which would permit suspension of the reporting obligations for ABS issuers when there are no longer asset-backed securities of the class sold in a registered transaction held by non-affiliates of the depositor.[7]

**Commission April 2010 ABS Proposal**

The Commission's actions on ABS have not been limited to Dodd-Frank related rulemaking. In 2009, we undertook a broad review of the regulation of ABS, including the disclosures, offering process, and reporting of asset-backed issuers, with the goal of enhancing investor protection. As a result of that review, on April 7, 2010, the Commission proposed substantial enhancements to Regulation AB and other Commission rules regarding asset-backed securities (the April 2010 ABS proposals).[8]

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[6] *See* Release No. 33-9176, *Issuer Review of Assets in Offerings of Asset-Backed Securities* (January 20, 2011), http://www.sec.gov/rules/final/2011/33-9176.pdf.

[7] *See* Release No. 34-63652, *Suspension of the Duty to File Reports for Classes of Asset-Backed Securities Under Section 15(d) of the Securities Exchange Act of 1934* (January 6, 2011), http://www.sec.gov/rules/proposed/2011/34-63652.pdf.

[8] *See* Release No. 33-9117, *Asset-Backed Securities*, (April 7, 2010), http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

These proposals were designed to improve investor protection and promote more efficient asset-backed securities markets.

The April 2010 ABS proposals sought to address a number of issues – some subsequently referenced in the Dodd-Frank Act, but others not. Among the proposals addressing issues referenced in the Dodd-Frank Act are proposals to repeal the current credit rating references in shelf eligibility[9] criteria for asset-backed issuers and establish four new shelf eligibility criteria, including a requirement that the sponsor of a shelf-eligible offering retain five percent of the risk and an undertaking to continue reporting under the Exchange Act so long as non-affiliates of the depositor hold any securities that were sold in registered transactions backed by the same pool of assets. The Commission also proposed requiring that, with some exceptions, prospectuses for public offerings of ABS and ongoing Exchange Act reports contain specified asset-level information (sometimes referred to as "loan-level data") about each of the assets in the pool.[10] The asset-level information would be provided according to proposed standards and in a tagged data format using eXtensible Markup Language – or XML.

Among the proposals addressing issues not referenced in the Dodd-Frank Act is a proposal to revise filing deadlines for ABS offerings to provide investors with more time to consider transaction-specific information, including information about the pool assets. In addition, the Commission proposed requiring, along with the prospectus filing, the filing of a computer program of the cash flow waterfall provisions. Finally, the

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[9] Shelf is the process under which a sponsor or depositor may register asset-backed securities to be offered on a delayed basis in the future through one or more offerings, or "takedowns," of securities off of the shelf registration statement.

[10] *See also* Section 942(b) of the Dodd-Frank Act, which generally requires the Commission to adopt regulations requiring an issuer of an asset-backed security to disclose, for each tranche or class of security, information regarding the assets backing that security.

Commission proposed new information requirements for the safe harbors for exempt offerings and resales of asset-backed securities and a number of other revisions to our rules applicable to asset-backed securities.

As we continue to work on the ABS rulemaking required under the Dodd-Frank Act, Commission staff is reviewing the comment letters received on these proposals and working to develop recommendations for the Commission that will harmonize these proposals with the regulatory revisions required under the Dodd-Frank Act.

**Conclusion**

Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.




**Statement of Henry V. Cunningham Jr., CMB**

**On Behalf of the**
**Mortgage Bankers Association**

**House Financial Services Committee**
**Subcommittee on Capital Markets and Government Sponsored Enterprises**

**"Understanding the Implications and Consequences of the Proposed Rule on Risk Retention"**

**April 14, 2011**

1717 Rhode Island Ave., NW | Washington, DC 20036 | www.mortgagebankers.org |
(202) 557-2700

Chairman Garrett, Ranking Member Waters and members of the subcommittee, thank you for the opportunity to testify on behalf of the Mortgage Bankers Association (MBA).[1] My name is Hank Cunningham, and I am President of Cunningham and Company, an independent mortgage banking firm with offices throughout North Carolina. I have more than 37 years of professional mortgage experience and currently serve as Chairman of the MBA's Residential Board of Governors, and I also serve on MBA's Board of Directors. Thank you for holding this hearing on the important subject of the proposed regulations to implement the credit risk retention provisions of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The Dodd-Frank Act instructs regulators to establish risk retention requirements specific to the type of asset being securitized. Furthermore, the act mandates specific and separate frameworks for residential mortgage-backed securities (MBS) and commercial MBS. Because the proposal's risk retention requirements for residential MBS are dramatically different from its commercial MBS requirements, MBA has arranged its testimony accordingly to provide the unique perspectives of the commercial and residential real estate finance markets.

## Residential Mortgage Market Perspectives on Risk Retention

Risk retention under the Dodd-Frank Act was intended to align the interests of borrowers, lenders and investors in the long-term performance of loans. This "skin in the game" requirement, however, is not a cost-free policy option.

Implementing this regulation will result in much higher costs for consumers where loans are subject to risk retention requirements, while cutting off access to credit to other consumers. Congress determined that this was an appropriate tradeoff to lower the level of risk to the financial system, and we understand the intent of the legislation.

Recognizing these costs, the Dodd-Frank Act allows an exemption from risk retention requirements for "qualified residential mortgages" (QRM). The congressional intent in providing this exemption was so the QRM definition would bound well-underwritten loans with full documentation and other sound underwriting requirements while excluding loans with riskier features such as negative amortization.

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[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

Regrettably, as we will explain, MBA believes the regulators' approach to the QRM, characterized by high down payment requirements and unduly restrictive qualifying ratios, is contrary to the explicit intent of Congress. For example, MBA believes the regulators have made the proposed QRM definition far too narrow. In fact, the QRM definition is so restricted that **80 percent** of loans sold to Fannie Mae or Freddie Mac over the past decade would not meet these requirements.

Additionally, the proposal raises several other major concerns addressed in this testimony including:

- What impact the proposal could have on the Federal Housing Administration (FHA) programs;
- The effect of the proposed government sponsored enterprise (GSE) exemption; and
- The economic impact of the proposal.

It is no exaggeration to say that both the risk retention requirements and the structure of the QRM exemption will affect who can and cannot buy a home for years to come. Considering the gravity of this rule and the many concerns it raises, MBA believes the comment period and discussion on the rule should be both extended and broadened as necessary to ensure there is ample opportunity for the public to present its views on the rule's profound implications before it is finalized.

We also would like to clearly state that while a move to a uniform national servicing standard may benefit the housing finance industry, servicing standards have no place in this proposal. While servicing standards may be germane to the risks of foreclosure, they are not relevant to a regulation intended to address underwriting criteria. Moreover, national servicing standards currently are being pursued through a separate regulatory action and they will include requirements beyond those in the proposal.

Including servicing requirements in the risk retention regulations will only cause confusion for consumers and lenders. For these and other reasons, we strongly request that Congress direct the regulators to exclude servicing provisions from any final risk retention regulations.

**Preliminary Assessment**

MBA recognizes the implementation of the risk retention requirements of the Dodd-Frank Act is a massive undertaking from both a procedural and substantive perspective. Procedurally, implementing these provisions requires the cooperation of an unusually large number of regulatory agencies. Moreover, the Dodd-Frank Act provides an unrealistically short timeframe for this work, evidenced by the fact that the regulators

have already missed the statutory deadline for issuing final risk retention regulations. Substantively, the task includes development of risk retention provisions for every single type of asset class and security structure. Considering the breadth of the work and these constraints, we appreciate the efforts of the agencies to develop this proposal.

Also, while we are still in the midst of our review, we are pleased with the flexibility that the proposal provides to securitizers in structuring the risk retention requirements. The various proposed structures represent a thoughtful effort to tailor risk retention obligations to a wide range of securitization vehicles.

We are disappointed, however, that this degree of flexibility is absent from the proposed QRM exemption.

**QRM Aspects of the Proposed Regulations**

Congress' intent in crafting the risk retention legislation was to address errant securitizer and originator behavior inherent in the originate-to-sell model. At the same time, Congress has repeatedly expressed in statements and letters to regulators its belief that the QRM should be broadly defined.

The QRM exemption from the risk retention requirements was intended to recognize that traditional mortgage loans – standard products, properly underwritten and with full documentation – were not the cause of this recent crisis, and securitization of these loans should remain unimpeded in order to return the MBS market to being among the most liquid in the world. By requiring a QRM exemption, the statute would keep consumer costs lower for QRMs, with higher costs for non-QRM loans. Accordingly, the Dodd-Frank Act requires the regulators to base the QRM definition on "underwriting and product features that historical loan performance data indicate result in a lower risk of default such as":

- Documentation of income and assets;
- Debt-to-income ratios and residual income standards;
- Product features that mitigate payment shock;
- Restrictions or prohibitions on non-traditional features like negative amortization, balloon payments, and prepayment penalties; and
- Mortgage insurance or other types of credit enhancement obtained at the time of origination on low down payment loans to the extent they reduce the risk of default.

This statutory framework is important for two reasons. First, it ensures that the definition is based on objective, empirical data rather than subjective presumptions. Second, it requires consideration of a multifactor approach to establishing the

parameters of the QRM in order to promote sound underwriting practices without arbitrarily restricting the availability of credit. While Congress did not quantitatively define "high quality" or "lower risk," it is clear the intent was to exclude certain higher risk loans, not to restrict QRM to a small subset of the market.

While Congress expected regulators to consider a range of factors to define QRM, these factors did not include either servicing standards or high down payments. Strong documentation, income to support the monthly payment for the life of the loan, reasonable debt loads, protections against payment shock, prohibitions on high-risk loan features like negative amortization and balloon payments, and inclusion of mortgage insurance or comparable credit enhancement for low down payment loans are the core factors that were identified because they lower the risk of default without unduly restraining credit.

MBA believes the regulators' approach to the QRM goes beyond and is contrary to the explicit intent of Congress. To qualify for a QRM under the proposal, the borrower must make a 20 percent down payment and have a maximum loan-to-value (LTV) ratio of 80 percent for purchase loans and a 75 percent combined LTV for refinance transactions, reduced to 70 percent for cash-out refinances. In addition to a 20 percent down payment, the borrower must have cash to pay closing costs. Additionally, a borrower's debt load must not exceed front-end and back-end debt-to-income (DTI) ratios of 28 percent and 36 percent, respectively.

In the analysis used to justify the QRM definition, the Federal Housing Finance Agency (FHFA) found that less than one third of loans purchased in 2009 by the GSEs, Fannie Mae and Freddie Mac, would have met these QRM requirements. This is notable because 2009 was, by most accounts, the most cautiously underwritten, liquidity-constrained market in generations. For example, the average LTV and credit score on Fannie Mae acquisitions in 2007 was 75 and 716, respectively. By 2010 the average LTV had fallen to 66 and the average credit score had risen to 760. Similarly, the average credit score on FHA loans has risen from 650 to above 700. And the few private-label deals that have been completed have had LTVs near 60 and average credit scores near 800. Individual lender decisions and market forces have pushed underwriting standards significantly tighter.

It is questionable why regulators would want to define QRM even narrower than the underwriting practices that prevail in today's much tighter credit market, such that two out of every three borrowers either will not qualify for a loan, or will have higher payments because of the loan's non-QRM status.

As noted by FHFA's analysis of GSE data, "for the 2005-2007 origination years, the requirement for product-type (no non-traditional and low documentation loans, or loans

for houses not occupied by the owner) was the QRM risk factor that most reduced delinquency rates." The intent of the risk retention requirement is to make it more difficult to originate and securitize the types of loans that caused the worst problems during the downturn. The QRM definition should, and does, explicitly target these riskier attributes. We see no reason to further cut off credit to borrowers by layering on other more onerous restrictions that were not implicated in the downturn.

The emphasis of the proposed regulations should be on creating a liquid securities market for QRMs, which are by definition more homogeneous. Homogeneous securities, such as those issued by the GSEs, trade in huge volume because investors can quickly assess their values. Heterogeneous securities, like those that were privately issued, tend to appeal to "buy and hold" investors, given the cost and difficulty of modeling the heterogeneity, and hence are bound to be less liquid. This also clearly necessitates that the QRM sector needs to be large enough to maintain liquidity over time. Even if QRMs are homogeneous with respect to credit, over time they will diverge with respect to coupon, with a resulting loss of liquidity.

MBA believes the QRM's 20 percent down payment requirement alone would provide a nearly insurmountable barrier to most first-time and low- and moderate-income borrowers achieving homeownership, notwithstanding that they otherwise may qualify for a mortgage. The QRM's DTI ratios also are considerably lower than the market has seen in recent years. In conjunction with the LTV requirements, the ratios will bar the door to even more borrowers who may have offsetting resources and payment behavior that under the proposal cannot be considered. Higher LTV loans may pose higher risks. However, these risks can be mitigated by compensating factors such as strong credit and full documentation.

While a reasonable and affordable cash investment or LTV requirement may be warranted – although they are not suggested by the statute – the rules should permit offsetting factors in the context of prudent underwriting. While reasonable DTI ratios were to be considered under the law, the ratios should not be unduly restrictive.

Historically, the reason underwriters focused on DTI ratios was to ensure that households had sufficient resources for necessities such as food, household utilities and transportation. For lower income households this is particularly important. However, for middle and higher income households the same DTI ratio may not be as burdensome. For example, consider a borrower whose monthly income is $4,000 or $48,000 annually. A $1,600 monthly mortgage payment, resulting in a 40 percent DTI would clearly be a burden, as it would leave only $2,400 for all other monthly expenses. Now consider a borrower who makes $144,000 annually, or $12,000 a month. A 40 percent DTI is equivalent to a $4,800 mortgage payment which may well be feasible for a strong credit borrower as it leaves $7,200 for other expenses. Underwriters are

carefully trained to consider compensating factors in determining whether to approve a prospective borrower. Making DTI ratios unduly restrictive, as clearly shown in FHFA's analysis of the data, will prevent many borrowers from getting lower cost financing.

**Regulators' Inconsistent Application of Statutory Criteria**

MBA also is concerned that the regulators appear to have applied a double standard with respect to the statutory requirement for empirical data. For example, the regulators chose not to include mortgage insurance or other credit enhancements as a factor for QRM eligibility because of the lack of supportive historical loan performance data. Conversely, the regulators included provisions regarding written appraisals, mortgage servicing and mortgage assumability without providing empirical evidence on how any of these factors lessen the risk of default. MBA's concern about the regulators' selective use of data is intensified by the fact that the regulators explain that empirical evidence must be used to substantiate any request to change the proposal. Ironically, while assumptions were made in the proposal without facts, facts are required to refute the assumptions.

**QRM Servicing Provisions**

As indicated, in order to be considered a QRM and exempt from the risk retention requirements, the proposal would require compliance with certain servicing standards. Specifically, the QRM's "transaction documents" must obligate the creditor to have servicing policies and procedures to mitigate the risk of default (within 90 days of delinquency) and to take loss mitigation action, such as engaging in loan modifications, when loss mitigation is "net present value positive." The creditor must disclose its default mitigation policies and procedures to the borrower at or prior to closing. Creditors also would be prohibited from transferring QRM servicing unless the transferee abides by "the same kind of default mitigation as the creditor."

MBA is extremely concerned with the inclusion of servicing standards in a QRM definition that was very clearly intended under the Dodd-Frank Act to comprise a set of loan origination standards only. The specific language of the act directs regulators to define the QRM by taking into consideration "underwriting and product features that historical loan performance data indicate lower the risk of default." Servicing standards are neither "underwriting" nor "product features" and while they may bear on the incidence of foreclosure they have little if any bearing on default. Accordingly, MBA strongly believes they have no place in this proposal.

Another very serious concern with incorporating servicing requirements into origination-related regulations is the fact that servicing processes and procedures begin after the loan's consummation and continue for the life of the loan – as long as 30 years. It is

problematic to combine into a single regulation origination standards that terminate at the loan's closing and servicing standards that commence at closing and continue for decades. As proposed, the QRM requirements are an attempt to regulate not only two different functions, but also two different timeframes.

Embedding servicing standards within the proposed QRM regulations will have unintended consequences that could actually harm borrowers. The proposal requires loss mitigation policies and procedures to be included in transaction documents and disclosed to borrowers prior to closing. Such a requirement codifies at the time of origination the servicer's loss mitigation responsibilities for up to 30 years. While servicers today have loss mitigation policies to address financially distressed borrowers, these policies continue to evolve as regulators' concerns, borrowers' needs, loan products, technology and economic conditions evolve. One need only look at the variety of recent efforts that have emerged such as the Home Affordable Modification Program (HAMP), Home Affordable Foreclosure Alternatives, FHA HAMP, VA HAMP, and proprietary modifications. A further example is the different set of loss mitigation efforts necessitated by Hurricane Katrina. In both situations, inflexible loss mitigation standards would not have been in the best interest of the public or investors.

The QRM proposal also is likely to make servicing illiquid by combining "static" loss mitigation provisions in legal contracts and borrower disclosures with the inability to transfer servicing unless the transferee abides by those provisions, even if more borrower-friendly servicing options become available.

The proposal also calls for servicers to disclose to investors prior to sale of the MBS the policies and procedures for modifying a QRM first mortgage when the same servicer holds the second mortgage on the property. This adds another level of complexity to the concerns raised above, notwithstanding the irrelevance of these provisions to underwriting, origination, and statutory intent.

**Economic Impact on Availability and Affordability of Housing Finance**

Mortgage underwriting is subject to the classic statistical problem of Type 1 and Type 2 errors. Type 1 error is the approval of a mortgage for a borrower who subsequently defaults. This error imposes large costs on the borrower and the lender. Type 2 error is the failure to approve a mortgage for a borrower who would have repaid the loan as scheduled. Committing this error causes both the lender and the borrower to miss out on the opportunity for a mutually beneficial transaction.

Before the financial crisis, policy makers encouraged the lending community to provide more financing for underserved market segments such as low-income, minority and first-time home buyers. Implicitly, policy makers sought to avert Type 2 errors. These

efforts to actively promote homeownership resulted in higher default rates. On the other hand, after the crisis, legislation was proposed to forbid mortgage lenders from making loans to borrowers who could not repay, in effect trying to ban Type 1 errors.

It is unrealistic to expect that either type of error can be eliminated completely. The practice of underwriting is an effort to try to cut down on both types of errors as much as possible. Tightening standards through a very narrow QRM definition will result in an increase in Type 2 error, but a reduction in Type 1 error. In other words, too many well-qualified borrowers will either not get credit, or will pay a very high price for it.

The Board of Governors of the Federal Reserve System (Federal Reserve) recently issued a report showing that nearly a quarter of loan applications are rejected. However, the denial rates tell only half the story. Many potential buyers have stopped applying for loans because they assume they cannot get one – even with good credit. Another factor keeping people out of the mortgage market is high down payment requirements. Approximately 20 percent of home buyers currently put down less than 20 percent on their homes, and half of that population puts down 10 percent or less. Given this reality, the proposed 20 percent requirement as part of the QRM framework would increase costs or potentially cut off access to credit for hundreds of thousands of creditworthy households.

Another issue that was not addressed in the proposal is why the housing markets of California, Florida, Nevada and Arizona fared so much worse than the rest of the country. The same loan level credit models that applied in California and Florida with such disastrous effect also were applied equally in the rest of the country. The failure of regulators to take into account the special factors in California and Florida led to an extremely tight QRM definition that effectively punishes the rest of the country for what happened in those states. Because many borrowers in these states bought homes with no money down, first-time home buyers in states such as South Dakota and Alabama will be required to come up with 20 percent down payments. Because speculators led to a massive over-building of condominiums and detached single-family homes in Florida, borrowers in states such as Texas and New Jersey will need spotless credit records and little other debt if they want to buy a home, or they will pay much more for their mortgages.

**Estimated impact on FHA**

It is not at all clear from the proposal whether the regulators reflected on the relationship between the proposed QRM definition and the FHA's eligibility requirements in light of FHA's exemption from risk retention requirements. The proposed QRM definition appears to conflict directly with the Obama administration's plan for reforming the housing finance system. In its report to Congress, "Reforming America's Housing

Finance Market," the administration made clear that it intends to shrink FHA from its current role of financing one-third of all mortgages, and one-half of all purchase mortgages.

We support FHA's role as a source of financing for first-time homebuyers and other underserved groups. However, because of the wide disparity between FHA's down payment requirement of 3.5 percent and the QRM's requirement of 20 percent, MBA is concerned that the FHA programs will be over utilized. While FHA should continue to play a critical role in our housing finance system, MBA firmly believes that it is not in the public interest for a government insurance program like FHA to dominate the market, especially if private capital is available to finance and insure mortgages that exhibit a low risk of borrower default.

MBA suggests a better solution is to allow the use of credit enhancements to offset part of the down payment requirement for QRMs to provide some of the financing for low down payment loans that FHA would provide.

**GSE Exemption**

The proposal includes an exemption from risk retention requirements for securities issued by Fannie Mae or Freddie Mac so long as these two GSEs are in conservatorship or receivership. The housing market remains severely weakened, and liquidity through the GSEs is still essential to the availability of mortgage credit. Additional risk retention restrictions applicable to the issuance of MBS by the GSEs would increase the GSEs' costs of funding and constrict the availability of otherwise scarce mortgage credit to consumers. At this time, given the weakness in the market, and the very narrow QRM proposal, we support the limited GSE exemption. However, we note that this exemption runs counter to the Obama administration's stated policy objective, as well as the emerging congressional preference, to attract additional private capital to the housing finance market. GSE reform measures hinge on the return of private capital. The proposed risk retention requirements, however, pose significant obstacles to private capital's return.

Although we support the exemption considering the fragility of the market, MBA is concerned that the GSEs or their regulator might unilaterally change the GSEs' loan eligibility requirements, possibly making the requirements even narrower than the QRM-eligibility criteria. This is a concern because while the QRM definition is being developed on an interagency basis with the opportunity for public comment, the GSEs on the other hand may alter their loan eligibility criteria at their own discretion.

**Non-QRM Issues**

MBA is concerned about the lack of a risk retention duration limit in the proposal. The purpose of the so-called "skin in the game" requirement is to hold originators and securitizers accountable for the quality of the loans they underwrite and securitize. Historical data indicates that any underwriting deficiencies will likely present themselves within a relatively short time following origination of the loan. During that time, it will be clear whether the loan was underwritten poorly, or the borrower misrepresented key information. After that point, the way a loan was underwritten has little bearing on the incidence of default. Instead, economic or life events that were unforeseeable at origination become the primary default determinants. Any risk retention requirement beyond this timeframe is essentially overcollateralization and a constraint on funds that could be redeployed into funding more loans to creditworthy borrowers.

Originators and securitizers should not be held accountable for the performance of a loan if it met the investor's guidelines and all applicable laws and regulations, but failed due to changing economic circumstances. For these reasons, we believe the regulators should clearly limit the duration of a securitizer's risk retention requirements to a reasonable time following the origination date.

The proposed rule also prohibits sponsors from monetizing excess spread by selling premium or interest-only tranches. If the sponsor sells interest-only or premium tranches at issuance of the MBS, the sponsor is required to place the proceeds in a cash reserve account, which would serve as the first-loss piece to the transaction. This restriction would greatly decrease the attractiveness of securitizations, as it would push issuers to realize gains over time rather than up front. As a result, issuers will need to devote greater balance sheet resources to securitizations. Furthermore, because these amounts become the first-loss piece of the securitization, historical up front profits now become risky, cash flows paid out over a longer timeframe.

Additionally, this risk retention requirement jeopardizes true sale, both from an accounting standpoint and from a legal standpoint, rendering securitization potentially uneconomical from an accounting perspective. Because the proposed rule references par value only, any downward rate movement between the time of loan origination and deal issuance would trigger a need for a reserve account even for a loan originated as a par loan. This makes it difficult, if not impossible, to hedge and rate lock borrowers. In essence, this portion of the proposal penalizes a securitizer for putting together a successful deal, i.e., one that sells for above its par value. Moreover, this penalty is layered on top of the five percent retention requirement.

**Operational Issues**

While we believe consumers will receive more favorable pricing for QRM loans as compared to non-QRM loans, MBA also believes the operational impact of the risk retention requirements will increase consumer borrowing costs regardless of whether a loan is QRM-eligible. For example, the proposal includes additional disclosure and certification requirements for both originators and securitizers. Moreover, some of the QRM-eligibility criteria do not presently have standard metrics. For example, in the proposal, the regulators cite the common industry practice of using credit scores in qualifying a prospective borrower for a loan. Instead of using credit scores in the QRM-eligibility matrix, however, the regulators incorporate so-called "derogatory factors" relating to a borrower such as payment, bankruptcy and foreclosure activity. For lenders accustomed to using credit scores instead of these derogatory factors, the proposal will entail reworking their underwriting, tracking and reporting systems and making other operational adjustments.

**Cumulative Impact of Regulatory Activity**

It is important to keep in mind that the risk retention regulations are not the only changes taking place in the financial services industry. We note that the Federal Reserve's Report to Congress on Risk Retention urged regulators to consider the credit risk retention requirements in the context of all the rulemakings required under the Dodd-Frank Act, some of which might magnify the effect of, or influence, the optimal form of credit risk retention requirements. MBA notes that the Securities and Exchange Commission's proposed modifications to Regulation AB, the new version of the Basel Capital Accord and the new securitization safe harbor provisions of the Federal Deposit Insurance Corporation also overlap the proposed risk retention regulations. Individually, each one of these actions increases the costs of credit, which in turn imposes further restrictions on the availability of affordable real estate financing. We urge Congress to maintain a high degree of vigilance so that the cumulative impact does not forestall the recovery in the housing finance sector.

The layering effect of multiple regulations on similar topics causes market disruptions in a number of ways. Multiple rulemakings perpetuate uncertainty in the market. For example, the agencies' proposed risk retention regulations overlap the "Qualified Mortgage" provisions of the Federal Reserve's future regulations implementing the Dodd-Frank Act's revisions to the Truth in Lending Act. The proposal also includes an exemption for securities issued by Fannie Mae and Freddie Mac while they are in conservatorship or receivership. Regardless of the status of the QRM rulemaking, uncertainty will persist until both of these issues are resolved.

Multiple rulemakings also raise the level of difficulty from a compliance perspective. As mentioned above, the entire financial services regulatory landscape is being transformed and the changes are likely to stretch the capacity of even the largest financial institutions, to say nothing of smaller community lenders.

**Regulatory Due Diligence**

MBA reiterates its recognition of the inherent challenges associated with issuing proposed regulations on such a complex topic involving a significant number of regulatory agencies. Considering the stakes involved, we believe it is in the interests of the regulators and the entities they regulate to avoid making hasty decisions. We believe it would be far better to allocate time and resources to issuing a final rule that is cogent and analytically sound rather than sacrifice quality for speed.

Distortions inevitably occur whenever the government decides to intervene in credit markets, whether with the promotion of under-priced credit through vehicles such as GSE affordable housing goals, depository institution Community Reinvestment Act requirements, or the restriction of credit through regulations such as those implementing the Home Ownership Equity Protection Act or the proposed risk retention regulations. The crucial decision is whether the regulations actually address the root cause of the problems and whether the cost of the distortion is offset by other benefits to the public and the markets. It appears the proposed risk retention regulations fail on both measures.

We therefore urge you to instruct regulators to assess and report to Congress on the impact of the proposal on the cost and availability of mortgage credit. We also request that you direct the regulators to extend the public comment period in order to give interested parties sufficient time to assess the impact and provide considered views on the proposal. The current 60-day comment period is inordinately short given the complexity, potential market impact, and significance of the subject. In this vein, we also request that Congress instruct the regulators to seek comment in a more proactive manner by conducting regional hearings on this proposal. Before these rules are adopted, the nation deserves that discussion.

## Commercial and Multifamily Real Estate Perspectives on Risk Retention

The Dodd-Frank Act mandated that the federal banking agencies and the SEC jointly promulgate rules applicable to the commercial mortgage-backed securities (CMBS) market. MBA believes that operating within the act's parameters, the regulators have worked diligently and met repeatedly with MBA to propose rules that would meet our mutual goals of a responsible and vibrant CMBS market. As noted below, MBA applauds the regulators for providing flexibility in certain areas, in concert with our policy. However, in their current form, elements of the proposed rule, such as the Premium Capture Cash Reserve Account, are unworkable. MBA will work with the industry and the regulators throughout the comment period to provide feasible alternatives to the proposed rules in areas that currently present challenges to the viability of the CMBS market going forward.

MBA supports elements of the proposed risk retention rule applicable to CMBS and will be seeking greater clarification and refinement of other parts of the proposed rule. Areas of the proposed rule that MBA supports include: (1) the flexibility afforded the issuer to select from a range of risk retention options, including the five percent vertical slice; (2) the ability of the issuer and originator to negotiate the allocation of risk retention via third-party, arms-length contractual agreements; (3) a qualified exemption of issuer-held risk retention when a third-party purchases the first loss-position; (4) a qualified exemption of the risk retention requirement when certain prescribed underwriting, product and other standards are followed; and (5) the definition of an originator which would not include commercial and multifamily mortgage bankers who do not provide loan funding for purposes of CMBS risk retention. MBA will be seeking additional clarification and, in some instances, modification of specific elements of the proposed rule that fall outside of existing commercial and multifamily real estate finance industry conventions, practices and norms in order to meet the goals of a vibrant and responsible CMBS market.

### MBA Commercial and Multifamily Risk Retention Principles

MBA is committed to facilitating the establishment of a fully-functioning, transparent, liquid and responsible securitization market for commercial real estate mortgages. The CMBS market involves a complex set of interactions among numerous stakeholders. Corrective remedies for this market should: (1) advance an alignment of interests among investors, issuers, originators, servicers and borrowers; and (2) support credible, safe and sound lending practices that reflect the needs and sophistication of CMBS investors. Consequently, static and narrowly defined government-prescribed regulations are ill-suited to address CMBS market challenges in a comprehensive manner. MBA promotes a robust and constructive dialogue to create a new CMBS program construct that works

for and is designed by the market. In terms of promoting a robust CMBS market, MBA believes any regulation should support the following principles:

- Support the efficient flow of mortgage capital from investors to borrowers;
- Help restore investor confidence and the ability of investors to accurately assess the risks in the collateral and in the securitization structure;
- Ensure risks are properly assessed, mitigated and/or priced by those who take them on or control them;
- Support credible, safe and sound lending practices that reflect the needs and sophistication of both the investors in commercial real estate securities and the owners of commercial real estate properties;
- Advance alignment of interests among investors, issuers, servicers, originators and borrowers;
- Increase transparency across all aspects of the market, assuring adequate information for investors while protecting individual privacy and proprietary business models;
- Promote accurate accounting that is understandable and reflects the true risks and benefits of securitizations; and
- Provide flexibility to allow for a number of different forms of risk retention and risk allocation.

**Proposed Rule's Method and Allocation of Risk Retention**

The above principles were used to develop MBA policy for CMBS risk retention. A central issue is that the proposed rules must offer flexibility that will facilitate competition. They must also support a variety of business models, helping them to develop and thrive in the recovering CMBS market. We are pleased that elements of the proposed rule allowed for flexibility in two important areas: (1) the form of risk retention; and (2) the allocation of risk retention between the originator and the issuer.

First, regarding the form of risk retention, the proposed rule allows issuers to select between seven forms of risk retention options. MBA supports inclusion in the proposed regulations of a 5 percent vertical slice as a mechanism for retaining necessary financial risk. This structure would not trigger consolidation of the entire CMBS issuance on the issuer's balance sheet under FAS 167, a major concern of MBA members.

Second, MBA strongly supports the proposed rule's approach for allocating risk retention between the issuer and originator. If an originator contributes 20 percent or more of the CMBS pool's loans, the issuer and originator may have a discussion regarding the allocation of risk retention between these two parties. However, the proposed rule does not force the originator to assume any of the retained risk and in

cases where the originator agrees to assume risk, this share cannot be more than the originator's pro-rata share of the CMBS.

The proposed rule specifies that the retained risk would be held for the duration of the CMBS. MBA will evaluate and comment in its letter to the regulators on whether this is an appropriate duration for retained risk.

**Premium Capture Cash Reserve Account**

Although not specified in the Dodd-Frank Act, the proposed rule introduces the concept of a Premium Capture Cash Reserve Account. Because CMBS transactions have an unique structure, one of MBA's priorities will be to thoroughly evaluate this reserve account concept and the impact it would have on reestablishing a functional CMBS market. MBA will also offer constructive alternatives to the proposed Premium Capture Cash Reserve Account in its response to the proposed rule.

**Hedging**

As a general matter, the proposed rule prohibits a securitizer from hedging its required retained interest or transferring it, unless to a consolidated affiliate. The rule would permit hedging of interest rate or foreign exchange risk; pledging of the required retained interest on a full recourse basis; and hedging based on an index of instruments that includes the asset-backed securities, subject to limitations on the portion of the index represented by the specific securitization transaction or applicable issuing entities. MBA will be working with its members to identify any other hedging strategies that would be appropriate for the proposed rule.

**Risk Retention Exemptions Under the Crapo Amendment**

The proposed rule reflects the flexibility authorized in the inclusion of the Crapo amendment to the Dodd-Frank Act. MBA strongly supports the ability to reduce retained risk if certain underwriting requirements are met or if a third-party purchases the first-loss position in a CMBS that meets certain proposed requirements. We will be working with MBA members and the regulatory agencies throughout the comment period to provide specific recommendations regarding the form and structure these proposed requirements should take.

Underwriting, Product and Other Standards
The Crapo amendment allows the regulatory agencies to specify the loan underwriting characteristics that would allow a commercial real estate loan to be classified as a "low risk loan" and thus be eligible for reduced risk retention requirements. The proposed rule specifies a zero percent risk retention requirement for loans that meet certain

underwriting and product standards. MBA supports reduced retained risk for loans that clearly meet the parameters of a low-risk loan. The proposed rule specifies an extensive inventory of these standards. During the course of MBA's evaluation of this portion of the proposed rule, MBA will examine the underwriting parameters of loans slated for securitization that meet the proposed definition of qualifying commercial real estate (CRE) loans, including the loan to value, debt service coverage ratios and the amortization and loan terms, as well as other proposed standards.

B-Piece Buyers in CMBS transactions
The regulatory agencies propose to exempt the issuers from the requirement to retain risk when a third-party purchaser ("B-piece buyer") buys the five percent horizontal risk retention slice and is subject to certain conditions. MBA supports reduced retained risk for CMBS whose first-loss position of five percent or greater is purchased and held by a third-party. Under the proposed rule, the B-piece buyer would have to meet six conditions to qualify for reduced risk retention.

During the course of MBA's evaluation of this portion of the proposed rule, MBA will be examining issues related to the specific role of the Operating Advisor, disclosure issues regarding the purchase price paid for the first loss position and other issues related to regulatory compliance.

**Conclusion**

With respect to commercial real estate, MBA is working hard to identify and implement positive CMBS program designs, structures and executions as the market returns. We also look forward to continuing our work with the regulators, both during the comment period and the 2-year implementation period to affect the Dodd-Frank Act's regulatory mandates. Through this rule making process and industry initiatives, MBA remains committed to fostering a fully-functioning, transparent, liquid and responsible securitization market for commercial real estate mortgages.

On the residential side, when finalized, the risk retention regulations will have a significant negative impact on credit availability and affordability for first-time, minority, low-to-moderate income homebuyers as well as others in the marketplace. While the real estate finance industry seeks to ensure better standards through the QRM exemption, we urge that they be redrawn to avoid unintended consequences.

These proposals are of the utmost importance to restoring a strong and stable housing and mortgage finance market, and we would be pleased to contribute our experience and insights throughout the process.




**Statement of:**

**Tom Deutsch**
**Executive Director**
**American Securitization Forum**

**Testimony before the:**

**House Financial Services Committee**
**Subcommittee on Capital Markets and Government Sponsored Enterprises**

**Public Hearing on:**

# Understanding the Implications and Consequences of the Proposed Rule on Risk Retention

**April 14, 2011**

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**TESTIMONY SUMMARY**

The American Securitization Forum ("ASF")[1] has long been supportive of further methods to align the incentives of issuers and investors of mortgage- and asset-backed securities. As such, we very much appreciate the hard work the joint regulators have put in developing the risk retention proposals released two weeks ago. In particular, significant strides were made to account for asset class differences as compared to rules implemented by the FDIC and proposals made by the SEC in 2010.

However, significant work still needs to be done to evolve these proposals into workable solutions. What is at stake is the risk of significant reductions in the availability of car loans, mortgages, student loans, credit cards, and business credit all across America if these rules are not appropriately implemented. Given that many engines of the U.S. economy are still sputtering and unemployment remains extremely high, the ASF advocates strongly that these rules not overreach to attempt to fix large swaths of the securitization markets that haven't seen any losses during an extreme economic downturn and instead are now powering economic revival in some sectors of the economy. Attempts to realign incentives in many types of securitization structures, where those incentives have been demonstrated through strong performance to be well-aligned between issuer and investor, only serves to risk harm to the American economy, American consumer and to investors, rather than to aid them.

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[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

As such, we seek in this testimony and later in our comment letter on these proposed risk retention rules for the regulators to specifically articulate that the new rules would not apply to a number of segments of the securitization market, including prime auto loan pools, government guaranteed student loans and sponsor supported asset-backed commercial paper that have all demonstrated extraordinary structural resilience in the most stressed of economic circumstances. In other areas such as corporate and municipal bond repackagings, the rules simply shouldn't have the legal authority to apply to these transactions, nor is there any evidence of misaligned incentives in these markets.

In other areas of the securitization markets, such as residential mortgages, we are quite concerned that the rules put the private markets at an enormous disadvantage vis-à-vis the government-backed market, which will ultimately keep the private markets on the sidelines, while American taxpayers continue to bear the risk on 95+% of new mortgages made in America. These rules should be encouraging the return of private capital by allowing for a broad enough definition of QRM that would allow for effective competition in the relative near-term between government-backed and privately offered transactions. Private offerings and private actors also have a litany of considerations that government offerings, particularly those in conservatorship, don't confront. These include key issues around accounting consolidation under FAS 166 and 167 that can have extraordinary implications for how depositary institutions allocate their risk-based capital.

Moreover, we would encourage the regulators to adhere to the legislative intent of Dodd-Frank in the final rules, rather than include new concepts such as national servicing standards and the newly proposed premium capture cash reserve account. These initiatives should be

undertaken as separate initiatives under their own legislative authority rather than bootstrapped onto a set of unrelated rules.

Finally, cumulative impact and need for coordinated implementation of these rules along with other areas of securitization reforms must be done in a decidedly deliberate manner, rather than in any piecemeal manner. As such, we call upon Congress to pass legislation that would require all government agencies to proceed with uniform implementation of these reforms rather than piecemeal, brash approaches such as the FDIC's securitization safe harbor that was just put into place a few months ago and has materially different provisions for risk retention than what was just proposed by the joint regulators two weeks ago.

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ATTACHMENT A: ROLE OF SECURITIZATION WITHIN THE FINANCIAL SYSTEM AND U.S. ECONOMY ....A-1

## I. Introduction

ASF submits this testimony to express our views relating to implementation of Section 941 (Regulation of Credit Risk Retention) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act" or "Dodd-Frank"). We support efforts to align the incentives of issuers and originators with investors of asset-backed securities ("ABS") and believe these incentives should encourage the application of sound underwriting standards by both the originator and securitizer in connection with the assets that are securitized. We believe that risk retention can aid in achieving this goal so long as the requirements ultimately prescribed are appropriately tailored to each class of securitized assets where misalignment of incentives have been demonstrated to have caused substantial losses.

Section 941 of the Dodd-Frank Act requires the Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve Board of Governors (the "Board"), the Office of the Comptroller of the Currency ("OCC") and the Securities and Exchange Commission (the "SEC" and collectively, the "Joint Regulators") to jointly implement rules to require any "securitizer" to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an "asset-backed security," transfers, sells, or conveys to a third party. Section 941 amends the Securities Exchange Act of 1934 (the "Exchange Act") to establish an alternative definition of "asset-backed security" (an "Exchange Act ABS") that is broader than the existing definition set forth in Regulation AB of the Securities Act of 1933 (the "Securities Act") and a definition for the term "securitizer" which is, generally, an issuer of Exchange Act

ABS or a person who organizes and initiates an Exchange Act ABS transaction by transferring assets to the issuer.[2]

The general standards for risk retention are set forth in Section 941, which requires a securitizer to retain "(i) not less than 5 percent of the credit risk for any asset" or "(ii) less than 5 percent of the credit risk for an asset" if the originator of the asset meets underwriting standards to be prescribed by the Joint Regulators. The regulations prescribed under Section 941 must also specify "the permissible forms of risk retention" and "the minimum duration of the risk retention." In addition, the regulations "shall establish asset classes with separate rules for securitizers of different classes of assets, including residential mortgages, commercial mortgages, commercial loans, auto loans, and any other class of assets that the Federal banking agencies and the SEC deem appropriate" and, for each asset class established, the regulations "shall include underwriting standards established by the Federal banking agencies that specify the terms, conditions, and characteristics of a loan within the asset class that indicate a low credit risk with respect to the loan." Additionally, Section 941 specifies that the regulations shall provide for certain exemptions as further described in this testimony.

In November and December of 2010, ASF submitted a series of preliminary comment letters to each of the Joint Regulators supporting the proposal of risk retention requirements that are tailored to each major asset class, including (i) our comment letter[3] relating to residential mortgage-backed securities ("RMBS") and the qualified residential mortgage ("QRM")

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[2] In a release of proposed rules relating to Section 943 of the Dodd-Frank Act, the SEC indicates its belief that the definition of Exchange Act ABS includes securities that are typically sold in transactions exempt from registration under the Securities Act and that the definition of securitizer is not specifically limited to entities that undertake transactions that are registered under the Securities Act. *See* pages 8 and 10 of Release Nos. 33-9148; 34-63029; File No. S7-24-10.

[3] *See* "ASF Comment Letter re RMBS Risk Retention & QRM," American Securitization Forum (November 12, 2010), available at http://www.americansecuritization.com/uploadedFiles/ASF_RMBS_Risk_Retention_Letter_11.12.10.pdf.

exemption (the "ASF RMBS Risk Retention Letter"), (ii) our comment letter[4] relating to auto ABS (the "ASF Auto Risk Retention Letter"), (iii) our comment letter[5] relating to ABCP (the "ASF ABCP Risk Retention Letter"), (iv) our comment letter[6] relating to credit card ABS (the "ASF Credit Card Risk Retention Letter"), (v) our comment letter[7] relating to student loan ABS (the "ASF Student Loan Risk Retention Letter") and (vi) our comment letter[8] relating to corporate debt repackagings (the "ASF Repack Risk Retention Letter" and collectively, the "ASF Risk Retention Letters"). In these comment letters, our membership sought to highlight the intricacies of each of these asset classes and stress the need for risk retention requirements that permit tailoring of the retention forms to each class of securitized assets.

The views set forth in the ASF Risk Retention Letters were consistent with the Dodd-Frank Act's directive to implement "separate rules for securitizers of different classes of assets" and reflected the primary recommendation of the Board of Governors of the Federal Reserve System in its October 2010 Report to the Congress on Risk Retention (the "Federal Reserve Study"), in which it stated:

> "Thus, this study concludes that simple credit risk retention rules, applied uniformly across assets of all types, are unlikely to achieve the stated objective of the [Dodd-Frank] Act—namely, to improve the asset-backed securitization process and protect investors from losses associated with poorly underwritten

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[4] *See* "ASF Comment Letter re Risk Retention for Auto ABS," American Securitization (November 22, 2010), available at http://www.americansecuritization.com/uploadedFiles/ASF_Auto_Risk_Retention_Letter_11.22.10.pdf.
[5] *See* "ASF Comment Letter re Risk Retention for ABCP," American Securitization Forum (November 22, 2010), available at http://www.americansecuritization.com/uploadedFiles/ASF_ABCP_Risk_Retention_Comment_Letter_11.22.10.pdf.
[6] *See* "ASF Comment Letter re Risk Retention for Credit and Charge Card ABS," American Securitization Forum (November 23, 2010), available at http://www.americansecuritization.com/uploadedFiles/ASF_Credit_Card_Risk_Retention_Letter.pdf.
[7] *See* "ASF Comment Letter re Risk Retention for Student Loan ABS," American Securitization Forum (November 23, 2010), available at http://www.americansecuritization.com/uploadedFiles/ASF_Student_Loan_Risk_Retention_Letter.pdf.
[8] *See* "ASF Comment Letter re Corporate Debt Repackaging," American Securitization Forum (December 14, 2010), available at http://www.americansecuritization.com/uploadedFiles/ASF_Corporate_Debt_Repackaging_Letter_FINAL_12-14-10.pdf.

> loans. ... Given the degree of heterogeneity in all aspects of securitization, a single approach to credit risk retention could curtail credit availability in certain sectors of the securitization market. A single universal approach would also not adequately take into consideration different forms of credit risk retention, which may differ by asset category. Further, such an approach is unlikely to be effective in achieving the stated aims of the statute across a broad spectrum of asset categories where securitization practices differ markedly. ... In light of the heterogeneity of asset classes and securitization structures, practices and performance, the Board recommends that rulemakers consider crafting credit risk retention requirements that are tailored to each major class of securitized assets."[9]

In addition, the Financial Stability Oversight Council ("FSOC"), chaired by Treasury Secretary Timothy F. Geithner, indicated in its January 2011 study that a risk retention framework should "[a]lign incentives without changing the basic structure and objectives of securitization transactions; [p]reserve flexibility as markets and circumstances evolve; and [a]llow a broad range of participants to continue to engage in lending activities, while doing so in a safe and sound manner."[10]

During the week of March 28, 2011, each of the Joint Regulators approved for release their notice of proposed rulemaking (the "Proposing Release") entitled "Credit Risk Retention" (RIN 1557-AD40; 7100 AD 70; 3064-AD74; 3235-AK96; 2590-AA43),[11] and requested public comment by June 10, 2011 (the "Proposed Regulations"). The Proposed Regulations provide a range of options that securitizers may choose from in meeting the risk retention requirements, including: (i) retention of a "vertical slice" of each class of interest issued in the securitization, (ii) retention of an "eligible horizontal residual interest" in the securitization, (iii) use of "L-Shaped" risk retention, which combines both vertical and horizontal forms, (iv) in the case of

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[9] The Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention, available at http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf, p. 3, 83-84.

[10] Timothy F. Geithner, Chairman, Financial Stability Oversight Counsel, Report to Congress on Macroeconomic Effects of Risk Retention Requirements, available at http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20%28FINAL%29.pdf, p. 3.

[11] *See* http://www.sec.gov/rules/proposed/2011/34-64148.pdf.

revolving asset master trusts, retention of a "seller's interest" that is generally pari passu with the investors' interest in the revolving assets supporting the ABS, (v) retention in its portfolio of a "representative sample" of assets equivalent to the securitized assets; and (vi) other risk retention options that purport to take into account the manner in which risk retention often has occurred in connection with the issuance of asset-backed commercial paper ("ABCP") and commercial mortgage-backed securities ("CMBS"). In addition, the Proposed Regulations set forth various exemptions, including exemptions based on certain "qualified" loans such as the QRM and qualifying automobile loans ("Qualifying Automobile Loans"), as well as hedging restrictions and the premium capture cash reserve account, which would be funded in certain circumstances by excess spread monetized at the time of securitization. In drafting the Proposed Regulations, the Joint Regulators have indicated that they have taken into account the diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which securitizers may have retained risk. ASF applauds these efforts to further tailor proposed rules to each asset class.

Within the context of these Proposed Regulations, we respectfully submit herein our comments regarding risk retention for RMBS, ABS backed by auto loans and leases, credit card receivables, and student loans, ABCP and municipal bond and corporate debt repackagings. We believe these comments are of critical importance to the Joint Regulators' goal of prescribing risk retention rules that properly align incentives without inhibiting the return of the securitization market and adversely impacting the availability and cost of credit. Simply put, the absence of a properly functioning securitization market, and the funding and liquidity this market has historically provided, adversely impacts consumers, businesses, financial markets and the broader economy. The recovery and restoration of confidence in securitization is therefore a

necessary ingredient for economic growth to resume, and for that growth to continue on a sustained basis into the future.[12]

## II. Impact of Proposals on Different Asset Classes

### A. RMBS

#### *i. Overall Effect on RMBS*

In crafting credit risk retention rules as mandated by Dodd-Frank, it is important to balance two objectives: 1) achieving an alignment of interests between sponsor and investor to restore needed credibility to the securitization market, and 2) avoiding imposition of requirements that will cause private (non-government guaranteed) securitization to be economically prohibitive as a funding alternative. Within this context, for RMBS, it is also important to be mindful of the nonpartisan policy objective of significantly reducing reliance on government-backed funding for residential mortgage loans through Fannie Mae and Freddie Mac (the "GSEs")[13], and ultimately giving the private markets the space over a reasonable time to step in as the key source of funding for mortgages in America.

If these objectives are balanced correctly, the risk retention rules will not dampen the return of the private RMBS securitization market, which will help loan originators to make mortgage credit available to low and moderate income borrowers at a reasonable cost. The availability of reasonably priced credit on equitable terms will enable more Americans to afford to invest in new homes, which will in turn stimulate the United States economy by preventing

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[12] For more information on the role of securitization within the financial system and U.S. economy, *see* Appendix A.
[13] *See* "Reforming America's Housing Finance Market - A Report to Congress," United States Department of the Treasury and United States Department of Housing and Urban Development (February 2010), p. 12-13.

housing prices from continuing to decline. Unfortunately, we believe that the Proposed Regulations fail to fully balance and take into account these important national objectives.

Our high-level observations about the effect of the Proposed Regulations on RMBS are as follows, and are supported by the discussion in the sections to follow:

- these proposals will impose increased costs that will make many securitizations economically unfeasible, given a prohibitively low return on capital for securitizers;
- the proposals use risk retention not just to ensure quality of underwriting within the "originate to distribute" model, but also eliminate viable business models for originating or purchasing loans for resale into the capital markets;
- the proposals make securitizations of higher interest rate loans more expensive (as compared to lower interest rate loans), and may result in further higher costs to less creditworthy borrowers; and
- the proposals worsen the existing non-level playing field between the GSEs and private securitizers by increasing the relative execution advantages of the GSEs as to non-QRM loans, thus impeding the bipartisan policy goal of winding down the GSEs over an appropriate timeline.

While seeking to align interests among private market participants, these proposals may result in a misalignment of the impacts of government policy on the housing finance markets.

The capital markets need a clear signal from the government as to whether public policy is, or is not, to encourage the return of a robust private RMBS market. These proposals signal to the market the unintended result of further entrenching government involvement in the housing markets. Reforms that can enhance the quality of asset underwriting and disclosure to investors

are welcomed by securitization market participants. Reforms that go too far in imposing costs and burdens on private securitization stunt the return of the private RMBS market, and would ensure that taxpayers will continue to bear the full exposure to housing finance markets indefinitely.

In November 2010, we submitted the ASF RMBS Risk Retention Letter[14] to the Joint Regulators setting forth specifically the views of our membership relating to the implementation of the risk retention provisions of Dodd-Frank for the RMBS market. In that letter, we raised many of the same issues discussed in this testimony.

***ii. Concerns with "Eligible Horizontal Residual Interest" Definition for RMBS***

The definition of an "eligible horizontal residual interest," which limits the types of first loss interests in a securitization that can be used to satisfy risk retention as a horizontal slice, is on its face too narrow and must be revised to accommodate securitizations of higher interest rate loans.

In a typical private RMBS offering, investment grade securities of the highest rating are used to provide term financing for a fixed pool of mortgage loans. Credit enhancement is typically provided by creating subordinated interests in the pool. The structures used to create subordination vary greatly, depending on the creditworthiness of the borrowers in the pool.

Prime borrowers are ones that meet conservative underwriting standards with respect to credit history, equity in the property, debt-to-income ratio, and the like, and typically have higher credit scores. Such borrowers qualify for the lowest available interest rates, in part because they have a stable and strong financial condition. In a securitization of prime loans, the difference

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[14] *See* "ASF Letter re RMBS Risk Retention & QRM," American Securitization Forum (November 12, 2010), available at http://www.americansecuritization.com/uploadedFiles/ASF_RMBS_Risk_Retention_Letter_11.12.10.pdf.

between the rates on the loans (net of servicing fees and other transaction level costs), and the rates on the securities issued, is very small and does not contribute meaningfully to credit enhancement. In such a securitization, the most subordinate class typically has attributes like those of an "eligible horizontal residual interest" as defined in the Proposed Regulations, in that it has a principal amount representing a portion of the principal balance of the loans in the pool, which bears interest at a rate similar to the rate on the other securities.

Non-prime borrowers are ones that do not meet these conservative underwriting standards for one or more reasons. Such borrowers may have had credit problems in the past due to loss of employment or health issues. They may have comparatively low incomes, or may not have funds available for a substantial down payment, resulting in higher loan-to-value ratios. Non-prime borrowers typically have lower credit scores than prime borrowers. However, these borrowers can be deserving of credit under prudent underwriting guidelines, although at a higher interest rate than would be available for the most creditworthy borrowers, given some elevation in the risk of default. In a securitization of non-prime loans, the difference between the weighted average of the rates on the loans (net of servicing fees and other transaction level costs) and the weighted average of the rates on the securities issued is referred to as "excess spread." That excess spread may be in the range of 0.5% to 1.0%, but since the interest attributable to this excess spread is paid on the entire balance of the pool over the life of the transaction, the present value of the excess spread could be equal to 4.0% to 8.0% (or higher) of the total pool balance. In securitizations of non-prime loans, the excess spread typically will be treated as the first loss class. Thus the first loss class may have no principal amount (or par value) initially, but it represents an entitlement to excess spread across the entire pool on a subordinated basis. In such transactions, there are typically also second and subsequent loss classes, which do have principal

amounts representing a portion of the principal balance of the loans in the pool, and which do bear interest on their own balances at a rate similar to the rate on the other securities.

In a non-prime securitization, an excess spread class that is the most subordinate class, if retained by the sponsor, would represent a retention of the credit risk of the assets in the pool. In any given period, excess spread received that is not used to cover current losses may be required under the documents to be used to pay principal on the senior securities. This creates overcollateralization, represented by the excess spread class, which is an interest in the principal amount of the pool that is available to cover future credit losses. Typically, once the overcollateralization reaches a certain level, excess spread thereafter may be released to the excess spread class. Yet this type of class would not meet the proposed definition of "eligible horizontal residual interest," to the extent that it is not structured as also having an initial principal amount of 5%, and even in that case the present value of the excess spread would not count towards the risk retention requirement.

As drafted, the Proposed Regulations do not appear to recognize an excess spread first loss class with no stated principal amount as a valid form of risk retention. This is because an eligible horizontal residual interest must at closing be "in an amount that is equal to at least five percent of the par value of all ABS interests in the issuing entity." We would request that this be clarified to permit a class that has either a par value, or a fair value, equal to 5% of the par value of all such ABS interests. Otherwise, even if the sponsor did retain the excess spread first loss class, it would also be required to retain a 5% vertical slice, or a 5% horizontal slice structured as part of the excess spread first loss class (for example, by combining the excess spread with an initial overcollateralization level of 5% of the pool balance). We do not believe that this result was intended. We note that in our ASF RMBS Risk Retention Letter to the Joint Regulators

expressing our views on the implementation of the risk retention requirements, we specifically requested that the rules permit the requirements for horizontal risk retention to be complied with through the retention of an excess spread first loss class.

***iii. Investor Concerns Relating to Horizontal Risk Retention Generally***

Our investor members harbor concerns about horizontal risk retention because if the servicer and the sponsor are affiliated, the servicer may be motivated to adopt servicing strategies that benefit the first loss tranche or equity interest over the other tranches. Our investor members note that because of this tension, it is critical that the uniform servicing standards currently being developed as part of the interagency effort (outside of QRM) require that servicers act in the best interests of all investors taken as a whole, without regard to any securities that the servicer or an affiliate may own.

***iv. Impact of "Premium Capture Cash Reserve" Rules on RMBS***

The premium capture cash reserve proposals within the Proposed Regulations are not contemplated by Dodd-Frank, and came as a surprise to observers. The intent of these proposals is to prevent the upfront monetization of excess spread by the sponsor, under the theory that allowing such monetization would effectively negate the economic exposure that a sponsor is required to retain. The premise appears to be that using profits generated by monetization of excess spread to finance or fund the required risk retention would make the sponsor indifferent to asset quality.

Unfortunately in the Proposed Regulations as drafted, premium capture was based on proceeds in excess of 95% of the par value of the securities issued. It appeared that premium capture would have gone beyond the mandate and legislative intent of Dodd-Frank, by adding on

to the 5% risk retention (in most cases) the entire value of the interests issued in the securitization over par.

We have since heard from representatives of some of the Joint Regulators that the intent of premium capture was only to ensure that the value of the 5% risk retention, particularly if held as a horizontal slice, is in fact worth at least 5% of the fair value of all securities backed by the pool. It is essential that the rules be clarified to make this clear. The intent of the premium capture should be limited to confirming that the value of the risk retention position is what it should be, and these rules must not act to further limit the total proceeds that can be realized from a securitization as may be the case if the Proposed Regulations were read strictly.

In addition, we question the assumption that using profits generated from issuing a securitization to at least partially fund risk retention would result in a sponsor not truly having "skin in the game." While it is possible that utilizing such profits to purchase the interests required to be retained could result in a reduced cash outlay by the sponsor, the retained interests would still need to be held on the sponsor's balance sheet. This will subject the sponsor to capital charge and other accounting implications, which would become more severe if the value of the retained interests decline, thereby giving the sponsor every reason to ensure that such interests retain their value.

Under these rules as proposed, a sponsor would have to create and fund a "premium capture cash reserve account" with cash in an amount equal to the excess of:

a) the gross proceeds (net of issuance costs) from the sale of all ABS interests to persons other than the sponsor, over

b) 95% (for vertical, horizontal, and other types of risk retention representing an interest in the securitization held by the sponsor) or 100% (for other types of risk retention) of the par value of all ABS interests issued.

We recommend that clause b) above be revised in substance as follows:

b) 95% (for vertical, horizontal, and other types of risk retention representing an interest in the securitization held by the sponsor) or 100% (for other types of risk retention) of the aggregate fair value of all ABS interests issued.

The premium capture cash reserve account would be required to bear first losses and thus would be subordinate to any horizontal slice risk retention. Furthermore, the Proposed Regulations would deem the amount of gross proceeds in a) above to also include the par value of any ABS interest retained by the sponsor (or fair value of any such interest with no face amount) if either 1) the sponsor does not intend to hold the interest to maturity, or 2) the interest is an interest-only type class and is not the most subordinate interest in the transaction. If an excess spread first loss class with no initial principal balance was retained by the sponsor, such retention would not trigger the requirement to establish a premium capture cash reserve account.

There are several concerns with these proposed rules.

First, it is vitally important that the rules be revised as described above to base premium capture on proceeds in excess of 95% of fair value of all ABS interests issued, and not their par value. This clarification must be made, because "par value" technically means the stated principal amount of a security. There are legal, tax and structuring constraints that generally do not allow for ABS interests to be issued with a total principal amount greater than the aggregate unpaid principal balance of the pooled assets. This is a particularly hard and fast rule when

securitizing mortgage loans using a REMIC tax election. This clarification is essential because otherwise:

- The cost of origination could not be recovered in a securitization. This includes out-of-pocket costs such as appraisals and title insurance, as well as the originator's overhead and profit on sale. As a result, originators would be compelled to impose more costs on the borrower in the form of points and fees; and
- It would be perhaps impossible to use interest rate hedges during the period between origination and securitization. If a sponsor used a hedge to protect against interest rate movements prior to securitization, and if interest rates were to go down, the sponsor would lose money on the hedge, but the offsetting gain that should have been available to cover the loss on the hedge will instead take the form of a premium value that must be deposited in the premium capture cash reserve.

Second, the deemed additions to gross proceeds for certain retained interests are unduly harsh. The same results could be achieved by 1) requiring the sponsor to fund the premium capture cash reserve account only on the actual sale of any retained interests post-closing, and 2) as to non-first loss excess spread classes, requiring the sponsor to deposit cash received from such classes as and when distributed into the premium capture cash reserve account. There is no reason to require an upfront deposit of the full value of these retained interests at the time of issuance, in order to achieve the stated regulatory objectives.

Third, the premium capture cash reserve rules will have the effect of encouraging sponsors to structure transactions so that all excess spread is moved to the bottom of the waterfall and made available as subordination. We are concerned as to how this will affect the economics of issuance. If substantially more excess spread is subordinated than is necessary to support a

5% horizontal slice risk retention, this could result in a less favorable execution, in turn leading to higher costs for consumers. This would be most severe for non-prime borrowers, because securitizations of loans to such borrowers create significant amounts of excess spread and the costs of originating such loans tends to be higher. This would result in credit being less available to, and more expensive for, low to moderate income mortgage borrowers.

Our investor members support reforms that seek to create a stable securitization market over time and in this vein, they are generally supportive of the concept that the Joint Regulators attempted to employ through the premium capture cash reserve account. The ability of issuers to monetize excess spread at the inception of a transaction can result in an issuer having less overall exposure to the securitization transaction than it would have had if the account was required to be funded. However, as currently proposed, the premium capture cash reserve account may result in a constriction of credit and an increased cost of capital. Investors are also concerned that a reduced availability of credit may put negative pressure on home values and, in turn, affect the trillions of dollars of outstanding ABS that investors currently own. Our investor members will continue to review this concept and attempt to provide an alternative solution that alleviates these concerns.

***v. Impracticality of "Representative Sample" Retention for RMBS; Suggested Alternative***

The proposal for a representative sample is not practical for use with RMBS offerings for the reasons discussed below. We suggest below an alternative, under which a 5% pro rata participation interest is retained by the sponsor and not transferred to the issuer of the securitization.

First and foremost, the representative sample methodology outlined in the Proposed Regulations requires that there be a minimum pool of 1,000 assets, from which the securitized pool as well as the representative sample must be drawn, and that all 1,000 of the assets be in the pool or the sample. This is not practical for jumbo prime residential loans (loans meeting all GSE underwriting criteria except for being larger than the permitted maximum balance), which are the most likely type of residential mortgage loan to initially find acceptance as the capital markets recover. We note that the recent landmark $289,529,000 registered RMBS offering by Sequoia Mortgage Trust 2011-1, was backed by a pool of only 302 loans, with an average balance of approximately $978,000. Even if the 1,000 asset minimum requirement did not apply, we believe that it would be very difficult, and potentially impossible, by any selection method to break out a sample of 15 or so loans such that all material characteristics of the sample were representative of the securitized pool to the degree required under the proposed rules.

We are not suggesting that a representative sample as outlined in the proposal should be available for such a pool. To the contrary, such a sample would likely not be considered to be credible risk retention by investors, because it likely would not perform in a manner representative of the pool. For a sample of such a small number, the delinquency rate of the sample would be driven purely by the number of loans that happened to be in default and their relative sizes, and it would only be a coincidence if that rate approximated the delinquency rate of the securitized pool.

Instead, a better approach for such a pool would be to permit the sponsor to retain a 5% pro rata participation in each asset included in the pool. Such a participation would have to be a pari passu pro rata interest in each asset, meeting the definition of "participating interest" under FAS 166, such that the selling sponsor would not have to treat the retained participation as

having been sold for purposes of GAAP. The 95% participation sold to the issuing entity, and the 5% retained interest, would share equally, on a pro rata basis, in all principal and interest payments on the loan as well as any servicing expenses and losses realized. Servicing of the entire loan (thus both participations) would be conducted by a servicer under a servicing agreement, so there would be no differences in how the participation interests are serviced.

We believe that this approach can be easily executed. Moreover, for "chunkier" pools consisting of a relatively smaller number of assets with relatively larger balances, this approach will be superior to the representative sample in terms of credibility. There will be no question that the retained participations are exactly representative of the securitized pool, and that the retained participation will perform exactly like the securitized assets. Without this alternative, the Proposed Regulations would discriminate against sponsors of "chunkier" pools by not offering a risk retention alternative that, like representative sampling, is most favorable in terms of making sale treatment under GAAP a possibility for the securitized assets.

We note that, in order for the 5% participation approach to be workable, it will be necessary for the 95% participation sold to the issuing entity not to be treated as a separate "security" under federal securities laws. Under Regulation AB and related rules, if a pooled asset is itself a security then additional registration requirements apply that would be unduly burdensome. While we believe that with appropriate contractual provisions such a participation should not be treated as a separate "security" under applicable case law, in order to use this suggested form of risk retention there would need to be clarification in the rules that the 95% participation would not be treated as a separate security under Federal securities laws, in light of

general statements that have been made by the SEC regarding its view that participations that are securitized should generally be viewed as separate securities.[15]

Our investor members oppose the representative sample form of risk retention set forth in the proposed rules because they believe it will be difficult to ensure that the sample of loans selected is in fact random and adequately represents the overall credit risk of the loans that are securitized. Investors believe that the alternative form of representative sample that has been proposed in this testimony is not only easier to employ, but also guarantees that the retained risk is representative of the securitized pool.

***vi. Limitations on L-Shaped Risk Retention***

The Proposed Regulations permit sponsors to meet the risk retention requirements by retaining a combination of a vertical interest and a horizontal interest (i.e., "L-shaped" risk retention). The Proposed Regulations specify that when utilizing L-shaped risk retention, the Sponsor must retain not less that 2.5% of each class of issued securities (the vertical component) and an eligible horizontal residual interest in an amount equal to at least 2.564% of the par value of all issued securities, other than those interests required to be retained as part of the vertical component (the horizontal component). We will urge the Joint Regulators to consider revising the regulations to permit greater flexibility with respect to L-shaped risk retention by permitting the percentages of retention at the vertical and horizontal levels to vary, for example by permitting a sponsor to retain not less than 3% of each class of issued securities and an eligible horizontal residual interest in an amount equal to at least 2% of the par value of all issued

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[15] *See, e.g.*, Asset Backed Securities, Securities Act Release No. 8518, 70 Fed. Reg.1506, 1529, n. 173 (Dec. 5, 2005).

securities. We believe these changes will provide needed flexibility to securitization sponsors while still meeting all the goals of the risk retention requirements.

***vii. Limitations on the Resecuritization Exemption***

We appreciate the Joint Regulators' efforts to provide for an exemption from the risk retention requirements for certain types of resecuritization transactions. However, we believe the exemption is overly narrow and does not further the Congressional goal of aligning the interests of originators and investors in order to improve the credit quality of the loans and other receivables underlying ABS transactions. That goal is only furthered by requiring a portion of the credit risk of the underlying assets to be retained in connection with the initial securitization transaction. Requiring risk to be retained as part of the resecuritization transaction does not provide any additional incentives to originators to employ better underwriting practices in connection with the origination of loans and other receivables. With respect to a resecuritization transaction, the loans and other receivables have generally been originated long before such transaction is contemplated, and retention of credit risk at the resecuritization level can in no way affect the procedures employed in connection with the origination of such assets. This is true irrespective of whether credit risk was actually retained in connection with the initial securitization. For these reasons, all resecuritization transactions should be exempt from the risk retention requirements, including those transactions that resecuritize assets that themselves do not comply with the risk retention requirements (which will be the case with respect to the resecuritization of assets initially securitized prior to the implementation of the risk retention rules).

We note that the Joint Regulators propose to adopt the resecuritization exemption pursuant to Section 15G(e)(1) of the Exchange Act, as amended, which permits exemptions that

would help ensure high quality underwriting standards, encourage appropriate risk management practices, improve the access of consumers and businesses to credit on reasonable terms or otherwise be in the public interest and further the protection of investors. As noted in the Release, resecuritization transactions have the potential to improve the access of consumers and businesses to credit on reasonable terms by providing a vehicle for investors to purchase interests in multiple smaller pools of ABS. The volume of resecuritization transactions will likely decrease substantially if credit risk is required to be retained at the resecuritization level. As discussed above, this proposed requirement will in no way help ensure that high quality underwriting standards and appropriate risk management practices are adhered to.

In addition, we note that restricting the exemption to resecuritizations that issue a single class of securities will result in the exemption having very limited practical effect, because private market resecuritization transactions generally involve the issuance of multiple classes of securities. In the current market environment, sponsors generally engage in resecuritization transactions in order create a class of securities that is more creditworthy, and hence will receive better ratings, than the underlying securities (which themselves have often declined in credit quality and been downgraded). This is accomplished by issuing one or more classes that are subordinate to, and hence absorb losses before, such senior class. This enables investors in the initial securitization transaction to acquire the resecuritized and higher-rated resecuritization securities in lieu of the downgraded securities they currently own. By limiting the exemption to single class resecuritizations, these types of transactions will likely become obsolete, which will eliminate the benefit these investors receive by holding the newly issued, higher-rated securities.

The Release appears to express concern that by permitting multiple class resecuritizations to be exempt from the risk retention requirements, the credit risk retained at the level of the

initial securitization would effectively be re-allocated among the multiple classes of securities that are issued, thereby diluting the effect of the risk retention requirements. We do not believe this would be the case. The portion of the underlying collateral that is retained by the underlying sponsors would not be transferred to the resecuritization trust and therefore would not serve as collateral for the newly issued securities, irrespective of whether one, or more resecuritization securities is issued. Furthermore, the types of resecuritization transactions discussed here are easily distinguishable from collateral debt obligations ("CDOs"). Unlike typical CDOs, the pool of collateral is established at the closing of the transaction and the sponsor generally does not have the ability to sell assets or purchase additional assets (i.e., they are not "managed pool" transactions). If the Joint Regulators wish to exclude CDOs from the resecuritization exemption to the risk retention requirements, our issuer members suggest that this could be accomplished by not permitting the exemption to apply to transactions with managed pools of collateral. Such an exception to the exemption would appear to exclude the types of transactions with which the Joint Regulators are most concerned, without excluding the large majority of private market resecuritization transactions.

Our investor members acknowledge that issuers must be able to credit and time tranche securities in a resecuritization in order to make such transactions economically viable. For this reason, they agree that the proposed rule regarding resecuritizations is too restrictive and will not be used in its current form. Our investor members agree that resecuritizations of existing ABS for which risk has already been retained should be exempt from the risk retention requirements, because the credit risk of the underlying ABS is the same credit risk that exists at the resecuritization level. However, to address the Joint Regulators' concerns about CDOs, our

investors suggest limiting the number of ABS transactions that underlie each class of securities in an exempt resecuritization to not more than a few.

***viii. The QRM Criteria***

ABS backed exclusively by QRMs are exempt from the risk retention requirements of the Proposed Regulations. Section 15G(c)(4)(b) of the Exchange Act (as added by Section 941 of Dodd-Frank) requires the Joint Regulators to promulgate the definition of QRM, taking into account "underwriting and product features that historical loan performance data indicate result in a lower risk of default." We discuss below certain of the specific criteria proposed for QRMs that our issuer members believe are overly restrictive and do not significantly further the statutory intent. We also discuss our investor members' general support for the proposed definition while also providing select criteria that they believe should be expanded.

*a. Credit History*

The proposed QRM definition requires that, at the time of origination of the loan, the related borrower is not currently 30 days or more past due on the payment of any debt obligation, has not been 60 days or more past due on the payment of any debt obligation in the past two years and has not been a debtor in a bankruptcy case or had any property repossessed or foreclosed upon in the past three years. The Release explains that the Joint Regulators determined, based on a review of historical data, that a borrower's credit score was a significant indicator of such borrower's ability to repay his mortgage loan. However, due to understandable concerns relating to utilizing credit scores provided by privately owned entities as a factor in meeting a regulatory requirement, the Joint Regulators decided to require compliance with the credit history criteria described above, which they believe serve as a reasonable proxy for credit score.

We generally agree that credit scores serve as a useful indicator of a borrower's ability to repay its loan. Our members believe that there is a known and understood correlation between credit score and probability of default. However, credit scores are complicated models that take into account many factors in addition to those included in the proposed credit history criteria. Our members are far less comfortable that the specific credit history factors listed above, as proposed to be used in the rule as a proxy for credit score, are predictive of probability of default in any established way. In other words, correlation of default risk to credit score is considered known and proven, but correlation of default risk to those specific credit history factors is considered to be not known or proven.

To underscore that point, we note that Appendix A in the Release, which seeks to establish an empirical basis between selected QRM criteria and historical default risk, uses data that are not based on those specific credit history factors, presumably because little such data was available. Instead, "to proxy the credit history restrictions in the proposed QRM definition, borrowers with FICO scores below 690 were deemed not to satisfy the proposed QRM credit history standards."[16] But ironically, the credit history standards themselves are intended as proxies for credit scores. We note that the large majority of the evidence cited in the Release points to a correlation between credit score and ability to repay, but does not cite evidence of a connection between the limited credit history criteria proposed and loan repayment.

We propose that the credit history criteria be eliminated from the definition of QRM because we do not believe they further the statutory goal of establishing QRM criteria that historically have resulted in a lower risk of default. In lieu of such criteria, we believe the Joint Regulators should consider substituting a minimum credit score requirement. We suggest that

[16] *See* Proposing Release, p. 199.

the minimum credit score be reconciled with the minimum credit score required by the GSEs to purchase a loan or guarantee ABS backed by a loan, which we understand to be 620. Utilizing the same credit score standard as is utilized by the GSEs will also have the benefit of limiting the competitive advantages enjoyed by the GSEs, which are discussed in further detail below. Alternatively, a higher credit score number could be used, such as 660, based on a further historical analysis of data that correlates the likelihood of default to specific credit score levels. Especially when combined with the other conservative underwriting criteria included in the QRM definition, we believe that there is room to set the bar at a level such as 660 and thereby serve many more borrowers, with only a marginal increase in risk.

While we understand the policy concerns surrounding the use of credit scores as a regulatory criterion, we note that use of credit scores is universally used in underwriting policies and procedures, including by the GSEs. We do not believe that there are serious concerns about the credibility or reliability of credit scores, and there is no perceived need to improve any aspect of the credit scoring process. In other words, the credit scoring system is not broken or deficient in any way, so there is no need to move to a replacement.

*b. Payment Terms*

The proposed definition of QRM requires adjustable rate mortgage loans to meet certain criteria in order to be considered QRMs. In particular, the proposal requires that the interest rate on the mortgage loan not increase by more than 2% in any 12-month period or by more than 6% over the life of the loan. We believe that these requirements are overly restrictive because they would exclude from the definition of QRM certain popular "hybrid" loan products that feature a fixed rate of interest for an initial period that begins to adjust after the expiration of such period. These loans are preferred by borrowers who want predictable payments during an extended

initial period, and are not quote "affordability products." These loan products generally provide for a fixed rate period of five to ten years and permit the interest rate to increase by up to 5% on the "first reset date" (i.e., the first payment date after the expiration of the fixed rate period). Importantly, these mortgage loans would otherwise be subject to the limitations on interest rate increases contained in the Proposed Regulations (i.e., no more than 2% in any 12 month period and no more than 6% over the life of the loan).

If these hybrid mortgage products do not qualify as QRMs, they will become more expensive for borrowers to obtain, forcing borrowers to choose between accepting increased costs on the mortgage transaction or acquiring a mortgage product less suitable to their needs. Accordingly, we encourage the Joint Regulators to revise the Proposed Regulations in order to allow for interest rate increases of up to 5% on the adjustable-rate mortgage loan's first reset date. The risk of default on any such mortgage loan will be substantially mitigated by the requirement that the borrower's debt-to-income ratio be determined based on the maximum interest rate that could be charged during the first five years of the loan term, as with all other adjustable rate loans.

*c. Ability to Repay*

The proposed QRM definition requires that in order for a loan to qualify as QRMs, the related borrower have a "front-end" debt-to-income ratio (i.e., the ratio of the borrower's monthly housing debt to the borrower's monthly gross income) that does not exceed 28% and a "back-end" debt-to-income ratio (i.e., the ratio of the borrower's total monthly debt to the borrower's monthly gross income) that does not exceed 36%. Our issuer members believe that these percentages are overly conservative and do not reflect the general standards applied by mortgage originators to the underwriting of prime residential mortgage loans. We believe that

requiring a "front-end" debt-to-income ratio of 33% and a "back-end" ratio of 38% would include a significantly larger number of borrowers with only marginally increased risk of default, especially when combined with the other conservative QRM criteria. Ratios lower than these numbers would exclude from the definition of QRM a significant percentage of high quality mortgage loans, unfairly making these loans substantially more difficult and expensive for low risk borrowers to obtain.

We urge the Joint Regulators to re-evaluate the available data relating to the effect of debt-to-income ratios on borrowers' ability to repay their loans in order to determine to what extent increasing the maximum debt-to-income ratios in the manner proposed would be likely to increase the risk of loan defaults. We note that the data reviewed by the Joint Regulators appears to compare loans originated with "front-end" debt-to-income ratios of 28% or lower and "back-end" debt-to-income ratios of 36% or lower to all loans originated by the GSEs between 1997 and 2009. We believe it would be more appropriate to compare loans with such debt-to-income ratios to loans with only slightly higher debt-to-income ratios consistent with those we suggest, in order to determine if the proposed changes would significantly increase the risk of default. We believe that a marginal increase in risk of default would be a small price to pay in exchange for making credit more available to deserving consumers at a reasonable cost.

We note that the proposed QRM criteria are generally very conservative and leave little room for the exercise of lender discretion (for example, the requirements relating to maximum loan-to-value ratios, maximum debt-to-income ratios and maximum points and fees that can be charged). We further note that, as discussed in more detail above, the requirements relating to the establishment of a premium capture cash reserve account make it less likely that originators will desire to originate loans that trade at a premium above their principal balance, since any

such premium will effectively need to be deposited into the securitization's premium capture cash reserve account. Therefore, it will be in the interest of loan originators to avoid creating loans that are worth more than par. Since the originator's ability to affect the value of the loan through flexible debt-to-income and loan-to-value requirements or by charging points and fees is limited by the QRM definition, they may choose to affect values by lowering the loan amounts they make available to borrowers. This could decrease the amount of credit available in the housing market to fund purchases, thereby further depressing home values. Permitting higher maximum debt-to-income ratios is one step the Joint Regulators could take to help prevent this outcome.

*d. Loan-to-Value Ratio*

The Proposed Regulations require that loans meet strict maximum loan-to-value ratio requirements in order to qualify as QRMs. Under the proposal, a loan made for the purpose of purchasing a property must have a loan-to-value ratio that does not exceed 80%. However, a rate and term refinancing (i.e., a loan made to refinance an existing loan in which the borrower does not receive any cash) cannot have a loan-to-value ratio in excess of 75%. We believe that both purchase loans and rate and term refinancings should be permitted to have loan-to-value ratios up to 80%. Since residential real estate values throughout the country are generally not rising, requiring refinance loans to have lower loan-to-value ratios will in many cases, require borrowers to contribute cash in order to take advantage of lower interest rates, or lock in fixed rates, by refinancing their mortgage loans. Such cash might otherwise be used by the borrowers to make purchases or otherwise be contributed to the economy in a beneficial manner. The fact that a borrower would have to pay cash in order to refinance may also discourage borrowers from refinancing into loans with safer and more economically desirable terms.

We note that the Release indieates that the Joint Regulators considered the role played by mortgage insurance in the residential mortgage market but determined that the presence of such insurance should not be a factor in determining the criteria for QRMs, since the existence of such insurance does not in and of itself reduce the potential for borrower default. As the Joint Regulators acknowledge, however, mortgage insurance does protect creditors (including investors in ABS) upon the occurrence of mortgage defaults. For that reason, we believe it is appropriate to allow the maximum loan-to-value ratio for purchase mortgages to be as high as 90% if mortgage insurance is obtained and other compensating factors exist that reduce the risk of borrower default (such as a credit score above a certain threshold).

*e. Points and Fees*

The proposed QRM criteria limit the points and fees that can be charged on a QRM to 3% of the total loan amount. In determining what types of charges constitute points and fees, the QRM criteria generally track the points and fees criteria set forth in the definition of "qualified mortgage" under the amendments to the Truth in Lending Act ("TILA") enacted by Dodd-Frank. This is consistent with Dodd-Frank's mandate that the definition of QRM be no broader than the definition of "qualified mortgage" under TILA. However, the QRM criteria diverge from this approach when addressing the treatment of bona fide discount points and certain bona fide third-party charges. The definition of "qualified mortgage" under TILA excludes certain bona fide discount points and bona fide third-party charges when calculating total points and fees, but the QRM criteria includes all such points and charges. The TILA criteria for determining if bona fide discount points and bona-fide third party charges can be excluded from total points and fees is reasonable and well established. Therefore, we believe that the QRM criteria should provide for the exclusion of bona fide discount points and bona-fide third party charges from the

calculation of total points and fees if such points or charges would be excluded under the TILA "qualified mortgage" definition.

*f. Views of our Investor Members on the QRM Criteria*

Our investor members generally support the definition of QRM proposed by the Joint Regulators. While the proposed definition is restrictive, the investor members believe that a clear, bright line rule is preferred to a definition that is overly complex, especially if the Joint Regulators are seeking to make the QRM the exception and not the rule. For example, our investor members believe that the prohibition on interest-only loans and the 2% interest rate cap on the first reset date appropriately limit payment shock on borrowers. In addition, our investor members share the concerns described by the Joint Regulators concerning the use of FICO scores, as such scores differ among consumer reporting agencies and may change over time.

However, there are a few criteria in the definition that should be expanded. First, our investor members agree that a rate/term refinance should be subject to an 80% LTV requirement. Borrowers who qualified for QRMs should not be prohibited from taking advantage of lower interest rates and refinancing on a subsequent date at the same LTV. The investor members do not agree that these types of refinancings result in an increased credit risk requiring 5% more home equity. Second, the investor members believe that the DTI and LTV requirements are overly restrictive when taken together. Instead, the investor members believe that a matrix approach should be used whereby the DTI or LTV requirement could be increased if a certain DTI or LTV threshold, as applicable, was met.

***ix. The Effect of the QRM Criteria on Availability of Credit; Issues relating to the GSEs***

Within the category of prime borrowers in terms of credit score, clearly many such borrowers and their proposed loan terms will not meet the QRM criteria. The highly conservative nature of the QRM definition will likely limit the availability, and increase the cost, of mortgage credit to consumers, particularly to those with low to moderate incomes. In light of the risk retention requirements that will exist upon the securitization of non-QRM loans, these loans will certainly feature higher interest rates, more points and fees and more onerous terms than QRM loans.

As currently contemplated, only the highest quality mortgage loans will qualify as QRMs and therefore QRMs will comprise only a small percentage of the mortgage market. The Release indicates that approximately 19.79% of all loans purchased or securitized by the GSEs during the period 1997 - 2009, and approximately 30.52% of loans in 2009 alone, would have met the QRM criteria. We believe that this percentage is far too small in light of the constrained nature of the current mortgage credit market. Even highly creditworthy borrowers are continuing to experience difficulties in obtaining mortgage financing, as uncertainty in the world financial markets in general and the mortgage market in particular make obtaining credit difficult. This problem will be substantially exacerbated, and the availability of mortgage credit to consumers will suffer, if the QRM definition is not expanded to include a greater percentage of the mortgage market.

In particular, we believe there is significant scope for easing the DTI restrictions. As indicated by the data in Appendix A to the Release, approximately 17.36% of all loans purchased or securitized by the GSEs during the period 1997 - 2009, and approximately 24.47% of loans in

2009 alone, would not have met the DTI criteria. Yet the increase in default rates for loans not meeting this criteria is only 1.38%, and is far lower than that for years other than 2004-2008.

We note that the Proposed Regulations provide a complete exemption from the risk retention requirements (including an exemption from the requirement to establish a premium capture cash reserve account) for RMBS guaranteed by the GSEs for so long as the GSEs operate under the conservatorship or receivership of the Federal Housing Finance Agency. In and of itself, this exemption is not unwarranted, given the fact that the guaranty by the GSEs is backed by capital support from the United States and it is not clear any feasible means would be available to require credit risk to be retained on securities guaranteed by the GSEs. We are concerned, however, that the very conservative terms of the proposed QRM definition, taken together with the risk retention requirements, will provide a significant and undue competitive advantage to the GSEs over private market participants. Securities guaranteed by the GSEs will be able to be securitized free from the risk retention requirements irrespective of whether such securities are QRMs, which will result in the non-QRMs loans backing such securities having lower costs to borrowers and more attractive terms than similar loans offered by private market participants. This will have the effect of increasing the portion of the residential mortgage market dominated by the GSEs, further entrenching the importance of their role in such market. This will make it substantially more difficult for Congress to carry out its efforts to restructure or wind down the GSEs, since a substantial percentage of consumers will be wholly dependent on the GSEs to provide them with affordable mortgage financing.

In our view, the appropriate way to level the playing field and avoid increasing the role of the GSEs in the residential mortgage market is to reduce the impact of the risk retention requirements on private market participants. This could be accomplished in a variety of ways.

We will urge the Joint Regulators to consider adjusting the criteria for QRMs, such that the vast majority of loans to prime borrowers that meet the product type and LTV criteria in the QRM definition (with the minor adjustments to those criteria that we propose), will qualify as QRMs. Reconciling the QRM criteria with the GSE requirements would enable private market participants to compete on equal terms with the GSEs for most of the mortgage market comprised of loans to prime borrowers.

In the alternative, we will urge the Joint Regulators to clarify the premium capture cash reserve account requirements and the terms of horizontal risk retention, and to revise the representative sample risk retention and the definition of QRM in the manner described above. Such modifications would have the effect of reducing the adverse impact of the risk retention requirements on private market participants, and thereby enable them to better compete with the GSEs and to serve the borrowing needs of the American homeowner.

***x. Additional "QRM Blend" Exemption***

As discussed in the Release,[17] section 15G(c)(2)(B) of the Securities Exchange Act of 1934 contemplates that the rules include underwriting standards for the various types of assets (including residential mortgage loans), which, if met, would allow such assets to qualify for a less than 5% risk retention requirement. However, the Joint Regulators did not propose any such standards for residential mortgage loans. We will urge the Joint Regulators to use this authority to create an additional "QRM blend" partial exemption from the risk retention requirements. Under this proposal, for a securitization backed by residential mortgage loans where at least 25% of the loans meet the QRM criteria, the 5% risk retention requirement would be ratably reduced by the proportion of the total pool that meets the QRM standards.

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[17] *See* Proposing Release, p. 157.

***xi. QRM Criteria - Inclusion of Servicing Standards***

Finally, there is another element of the QRM definition that goes well beyond the mandate and legislative intent of Dodd-Frank for criteria that relate to underwriting and product features. This is the requirement that the mortgage loan documents contain an undertaking by the lender to maintain certain servicing policies and procedures. There is no evidence, either in the legislative history or the language of Dodd-Frank, that Congress intended to include servicing standards as part of the risk retention mandate. In fact, incorporating servicing standards into the QRM definition would have the peculiar result of regulating the servicing of the highest quality borrowers, those with the least risk of encountering servicing issues or needing loss mitigation, while the bulk of the market, consisting of borrowers with a greater need for loss mitigation, would be left unregulated.

The proposed QRM definition requires the loan documents to include policies and procedures that 1) require commencement of loss mitigation efforts after 90 days delinquency, 2) allow for loan modifications if the resulting net present value would be greater than foreclosure proceeds, 3) address how the lender will service any second lien loan on the same property (when the lender services both the first and the second lien loan) and 4) include servicing compensation arrangements that are consistent with the creditor's commitment to engage in loss mitigation activities. There must also be an undertaking not to transfer servicing to any servicer who does not maintain such policies and procedures. We understand and appreciate the regulatory imperative for national servicing standards that address the above issues and our members are generally supportive of this effort. But, as noted in the Release, there is a separate interagency effort among certain Federal regulators to develop national servicing standards that will apply to all servicers of residential mortgage loans. We believe that this effort should not be

rolled out on a piecemeal basis, and that the QRM definition is not the right time and place for even a limited preview of these criteria. The key to success for such criteria is that they should be universal. As proposed in the Release in the form of an additional QRM criterion, these standards would not apply to loans that are sold to, or securitized by, the GSEs. Due to the restrictive nature of the QRM criteria, these standards would apply to only a small portion of the non-GSE market, with that segment being the most creditworthy borrowers, who of course are the least likely to need loss mitigation. We frankly believe that it is just not good public policy to apply these nascent and still developing standards to this subset of new originations.

Another major concern about this criterion is that the requirement to maintain such servicing standards would be embedded within the loan documentation. We do not understand why the proposal is to include the requirement in the loan documents, as opposed to simply having regulations that apply to servicers stating that they must maintain such policies and procedures. The inclusion of such standards will further complicate the closing process, creating yet more pages of documents for already overwhelmed borrowers to read and try to understand. In addition, if the regulators determine in the future that it is appropriate to change the mandated servicing standards, such standards will either not be able to be applied to existing loans or the borrowers will need to consent to modifications of their loan documents to reflect the new servicing standards. It would likely be exceedingly difficult to obtain the consent of borrowers to such modifications after the closing of their loans.

We believe that compliance with the national servicing standards under development should be a matter of regulatory compliance only. We note that this is consistent with the recent efforts undertaken by Congress to regulate the activities of servicers, such as through the establishment of safe harbors for certain loss mitigation practices in the Helping Families Save

Their Homes Act of 2009. By placing the requirement to maintain such policies and procedures in the loan documents, this approach invites the borrower to raise as a defense to foreclosure claims that 1) the servicer's policies and procedures did not meet the regulatory requirements as per the covenants in the loan documents, and 2) the servicer failed to comply with its policies and procedures in servicing the mortgage loan. In America's litigious environment, such claims, whether valid or specious, can easily be foreseen. We believe that it would not be good public policy to effectively grant to borrowers a private right of action to enforce these regulatory requirements. The Home Affordable Modification Program as well as other loan modifications were not structured to give the borrower a private right of action. Furthermore, by attaching these potential defenses in foreclosure to QRMs, but not simultaneously to non-QRMs, this aspect of the criteria would actually make QRMs more risky than non-QRMs from the investor's perspective, which is contrary to the Dodd-Frank mandate. If just one judge in one foreclosure action ruled that the servicer's policies and procedures did not comply with the QRM criteria, the QRM status of all loans serviced by that servicer would be questionable and potentially cause significant losses to institutional investors. The inclusion of servicing standards in the loan documentation also raises the moral hazard of enabling unscrupulous borrowers to better understand the length of time for which they may avoid paying their mortgages without fear of significant consequences.

As to the specific elements of the required servicing standards, we note that in some cases it will be burdensome on the borrower to commence loss mitigation at 90 days. The requirements regarding second liens are very unclear, and do not at all address the key problem with loss mitigation on a first lien where the second lien is serviced by a different servicer, or on behalf of different investors. In addition, we do not believe it is appropriate to introduce

requirements relating to servicing compensation in regulations that relate solely to QRMs. If such requirements are to be developed at all, they should be developed as part of national standards that apply to all loans. Finally, any requirements for national servicing standards must contain flexibility for those standards to develop and evolve over time. Given that under Dodd-Frank, all six regulators would have to affirmatively agree on the need to evolve these servicing standards AND to agree on the appropriate evolution of these standards, our members do not believe that there will be appropriate flexibility in the evolution of these standards.

***xii. The QRM Criteria and the "Qualified Mortgage" Definition***

The amendments to TILA enacted by Dodd-Frank provide that a lender may not make a mortgage loan without first determining that the borrower has the ability to repay that loan, and provide that such ability to repay shall be deemed to exist if the loan is a "qualified mortgage." "Qualified mortgage" is defined by the amendments to TILA, but the definition is subject to revisions by the Board. The Board has not yet weighed in on the definition, but is generally expected to issue significant changes. As a result, there is confusion among market participants over the interplay of these two types of mortgages and the degree to which they will overlap. We believe it would be useful for the Board to issue a release indicating the revisions they propose to make to the "qualified mortgage" definition in order to provide market participants with a more appropriate context in which to provide additional comments on the QRM definition.

**B. Auto ABS**

***i. Proposed Forms of Risk Retention for Auto ABS***

Our motor vehicle sponsor members (the "Auto Sponsors") strongly believe that a range of risk retention options should be available for motor vehicle securitizations and are pleased that the proposal would allow them to satisfy the risk retention requirement by (i) holding vertical exposures; (ii) either holding or cash-funding horizontal exposures; (iii) holding "L-shaped" exposures; (iv) holding a representative sampling of unsecuritized assets; or, (v) for revolving master trust securitizations of dealer floorplan receivables, holding a *pari passu* seller's interest. By suggesting a framework where a combination of risk retention options is made available to Auto Sponsors, the proposal follows, in part, the recommendations that we made in the ASF Auto Risk Retention Letter, dated November 22, 2010, in which we outlined both this preference and proposed structures for certain of these forms of risk retention. As discussed further in this testimony, although our Auto Sponsor and auto ABS investors agree on certain of the points made herein, they do have some differing opinions on other topics.

The Auto Sponsors are concerned that two of the forms of risk retention that could be the most useful for them—horizontal exposures and representative sampling—were not drafted in a way that is consistent with our proposals in that prior letter and will need to be clarified or revised significantly to make them appropriate and workable options for their transactions. Furthermore, they believe that the proposal should be revised to allow them greater flexibility to combine different forms of risk retention in a securitization and to modify the manner in which the exposures are held over time, which would achieve the goals of risk retention while reflecting the current structures of their transactions and investors' preferences. With the following changes, the Auto Sponsors believe that they would have access to a menu of options that would

achieve the goals of risk retention while also providing them with the necessary flexibility to ensure that they are able to fund their loan origination businesses efficiently through the issuance of ABS, even if the securitization market changes over time.

Before setting forth the Auto Sponsors' specific proposals, we would also note that virtually all motor vehicle securitizers already have substantial involvement with the ABS they issue, as they originate and service the collateral that comprises the asset pool and retain risk exposure through a subordinated residual interest.[18] These features, when considered in the context of the excellent historical performance of the motor vehicle ABS market,[19] indicate that motor vehicle securitizers have traditionally maintained strong alignment of interests with their ABS investors and why the motor vehicle ABS market remains the most vibrant portion of the United States ABS market.[20]

We fear, however, that if the risk retention rules do not recognize the current forms of risk alignment that the Auto Sponsors presently maintain and instead demand additional, expensive risk retention then there will be a significant impact on consumers. The Auto Sponsors believe that both individual consumers and businesses would face a more constricted credit market in this circumstance, resulting in fewer motor vehicle financing options and higher costs for purchasing or leasing vehicles. Motor vehicle dealers, which constitute a large number of the nation's small businesses, would also likely face restrained and more expensive credit in

[18] The subordinated residual interests that the Auto Sponsors presently retain in their securitizations do not fit squarely within the proposed definition of an "eligible horizontal residual interest." Given the successful risk alignment that the Auto Sponsors have traditionally achieved with their investors by retaining subordinated residual interests, they believe that the revisions to the proposed form of horizontal risk retention set forth in Section I.a. are appropriate and necessary, at least with regard to motor vehicle securitizations.

[19] The Auto Sponsors are unaware of any principal losses or missed interest payments on their ABS during the past twenty years, including during the recent financial crisis.

[20] For the period from January 1, 2008 through March 31, 2011, ABS backed by prime automobile loans, subprime automobile loans, motorcycle loans, automobile leases and motor vehicle dealer floorplan receivables together accounted for 40.1% of the domestic ABS market.

financing their inventory and assisting their customers with financing choices. In turn, the manufacturers whose sales the Auto Sponsors support may sell fewer vehicles, which will harm job growth, investment and the broader economy. For all of these reasons we believe that it is imperative that the risk retention rules be revised to reflect the current state of the motor vehicle securitization market and to allow the Auto Sponsors to continue to retain risk exposure to their securitizations in the ways that have been so effective for at least the past two decades.

*a. Horizontal Risk Retention*

In motor vehicle securitizations, the securitizer or an affiliate[21] generally retains ownership of the first-loss position in the transaction by holding an interest that we refer to in this section as a "subordinated residual interest." A subordinated residual interest is an equity ownership or debt interest in an issuing entity that is subordinated to all other tranches of issued ABS of the related series and that represents the right to receive cashflow at the most subordinated level of the flow of funds. To the extent that on any distribution date all other issued ABS have received all principal and interest payments due to them, all of the issuing entity's fees and expenses (e.g., servicer fees) have been paid in full and all of the securitization's credit enhancement is at the investor-desired levels,[22] the subordinated residual interest is typically allowed to receive any excess payments generated by the asset pool. The Auto Sponsors and most ABS investors strongly believe that retention of this subordinated

[21] In almost all motor vehicle securitizations the residual interests are held throughout the life of the transaction by a consolidated affiliate of the Sponsor, typically the securitization's "depositor". In many cases this arrangement is necessary to achieve the bankruptcy treatment of the securitization that investors demand. Because transfers to such consolidated affiliates would be permitted at any time pursuant to the Proposed Regulations, we believe that it would also be appropriate to modify the Proposed Regulations so that any risk retention can initially be held by those consolidated affiliates as well.

[22] In the motor vehicle ABS market many transactions feature reserve accounts that are available to fund payments of certain principal and interest on the ABS and certain senior fees and expenses of the issuing entity and that are maintained at a specified balance with the securitization's cashflow. Furthermore, transactions often feature overcollateralization that is maintained or increased over time by using excess interest collections on the pool assets to pay down the principal on the ABS more quickly than principal is collected on the pool assets.

residual interest as horizontal risk retention is highly effective in aligning incentives between securitizers and investors and that allowing retention of such interests (so long as they are sized appropriately) should be a permissible form of horizontal risk retention for motor vehicle ABS.

In many ways the subordinated residual interests that Auto Sponsors typically retain already largely share two of the three principal characteristics of the proposed "eligible horizontal residual interest."[23] First, the subordinated residual interests are the first ABS interest in the respective securitization to bear the burden of losses on the securitized assets until they have been fully depleted, which corresponds to clause (1) of the "eligible horizontal residual interest" definition. Second, they have the most subordinated claim in the transaction's waterfall to any collections on the pool assets, which corresponds to clause (2) of the "eligible horizontal residual interest" definition. We believe that these characteristics alone are appropriate and sufficient to cause a subordinated residual interest to qualify for horizontal risk retention. However, the third criteria of the proposed definition—that an "eligible horizontal residual interest" is not permitted to receive any principal payments other than a proportionate share of scheduled principal payments collected on the pool—is inconsistent with the way subordinated residual interests currently operate in motor vehicle ABS and is an unnecessary, inappropriate and uneconomical restriction.

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[23] In our full comment letter on the Proposed Regulations the Auto Sponsors will propose specific revisions to the definition of "eligible horizontal residual interest" so that the term can be more appropriately applied to motor vehicle ABS. For example, motor vehicle loan ABS deals do not have a "loss allocation" mechanism each period (which is envisioned in the Proposed Regulations), but the subordinated residual interest is nonetheless the ABS interest that would be the first to have its distributions reduced or eliminated in a particular period if there are losses on the asset pool or other cashflow disruptions. Appropriate revisions to the definition would preserve its "first loss" intent while not inadvertently excluding horizontal risk retention in traditionally structured motor vehicle loan securitizations. Furthermore, there are different structures and terminologies that are used across the motor vehicle loan, lease and dealer floorplan asset classes that all will need to be properly reflected so that horizontal risk retention can be used in any of these three types of motor vehicle securitizations.

As described above, in motor vehicle ABS the subordinated residual interest may receive distributions on the pool assets in any period, so long as the senior ABS have all received their required principal and interest, all issuing entity fees and expenses have been paid and all credit enhancement that is funded or maintained with cashflow from the pool assets is at its then-required level. Preventing payments on the subordinated residual interest when the deal is fully performing would not serve any purpose other than to retain more credit enhancement within the securitization than the sponsor, investors, underwriters and rating agencies had previously determined was needed to protect investors against a multiple of expected losses, and all at a time when, rather than experiencing losses or a diminution in credit enhancement, the deal was paying on schedule and generating excess collections. Furthermore, in motor vehicle ABS, collections are not segregated into principal and interest collections and applied in separate waterfalls, as is often the case in RMBS and certain other asset classes. Therefore, preventing excess payments on the subordinated residual interest other than from "scheduled payments of principal" on the pool assets would require that the securitizations separately track and account for interest, "regular" principal and "other" principal collections as they flow through the waterfall in a manner that is inconsistent with reporting and cash application for any motor vehicle ABS that is in the market today.

The Auto Sponsors would instead suggest that the only limitation that should be placed on distributions on the subordinated residual interest is that the value of the interest[24] after giving

[24] The Auto Sponsors interpret the references in part (c)(3) of the horizontal risk retention section to "estimated cash flows and the discount rate used" to calculate the values of ABS interests to imply that the retained horizontal interest could have a number of components at any time, including the current amount of overcollateralization and the discounted present value of any expected excess interest to be received on the interest but will request that a clear statement of this appear the final release. Similarly, the Auto Sponsors believe that cash that is on deposit in a securitization's reserve account and that is available to fund shortfalls in payments on the ABS interests (other than

effect to the distribution should not, as a percentage of the value of all ABS interests in the securitization after distributions on the related date, be decreased below the lower of (1) five percent of the then-current aggregate value of all ABS and (2) the percentage interest represented by the subordinated residual interest immediately prior to the distribution. Allowing payments that are consistent with the securitization's waterfall that maintain the retained interest at or above the required five percent level would preserve the securitization's mandated level of risk retention while preventing the transaction from building or maintaining a surplus of credit enhancement. It is also consistent with the provisions in the rules that would allow transfer of a portion of a residual interest to a third-party so long as the required risk retention is still maintained. Furthermore, allowing payments that maintain a level below five percent would result only if the subordinated residual interest had already absorbed losses that otherwise would have affected the more senior ABS interests in the transaction. If the sponsor were required to maintain excess collections in the deal and effectively fund the subordinated residual interest back up to five percent then it would be at risk for the same loss a second time and ultimately would be forced to have greater than the required five percent exposure to the securitization. If a securitization's investors do not desire these additional cash-capture features then the risk retention rules should not separately mandate them.

For these reasons, the Auto Sponsors will request that the sections of the Proposed Regulations regarding horizontal risk retention be modified as described above to match the horizontal risk that is presently retained as a "subordinated residual interest," at least as the rules are applicable to motor vehicle ABS. The historical performance of motor vehicle

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any interest retained for horizontal risk retention purposes) should be included as a component of the retained horizontal interest's value and will request that this be clearly stated in the final release.

securitizations illustrates that this current model of horizontal risk retention provides an appropriate alignment of interests between securitizers and investors and imposing further conditions on this method of risk retention would only hinder the issuance of motor vehicle ABS and negatively impact the availability of credit to consumers and businesses.

*b. Representative Sampling*

An Auto Sponsor selects the pool to collateralize its motor vehicle ABS from the portion of its portfolio that meets the prescribed securitization pool criteria, with no adverse selection permitted. The other receivables that remain unsecuritized after a pool is selected typically were originated using substantially the same underwriting criteria as the securitized receivables and then remain unsecuritized, at least temporarily, and are financed wholly by the Auto Sponsor. Furthermore, many Auto Sponsors maintain a significant portfolio of unsecuritized receivables at all times. For these reasons, the Auto Sponsors appreciate that the option to maintain risk exposure to their securitizations by holding a representative sampling of receivables (an "Unsecuritized Pool") may be an attractive option in certain instances. However, there are a variety of reasons that the proposed Unsecuritized Pool rules are unnecessarily complex and burdensome and, in their present form, likely would not be utilized in the motor vehicle ABS markets.

The Auto Sponsors believe that complying with a specified pool requirement is impractical and inefficient in their market, where an individual securitizer may maintain a portfolio of hundreds of thousands or even millions of originated and serviced loans. Therefore, the Auto Sponsors expect that the final comment letter will include a proposal that would allow satisfaction of the Unsecuritized Pool requirement by maintaining a revolving pool of

unsecuritized assets that is, nonetheless, representative of the corresponding securitized pool and its risk profile.

Alternatively, if Unsecuritized Pool risk retention must be conditioned upon maintaining a specified pool of assets, then achieving the goal of aligning an Auto Sponsor's exposure with its investors' can be achieved through much less burdensome methods than those that are described in the Proposing Release. Rather than mandating the manner in which the Unsecuritized Pool is constructed, the rules instead should only require that the Unsecuritized Pool be selected at the same time that the securitization's asset pool is selected, utilizing the same selection criteria and no adverse selection. An assessment at the time that the respective pools are selected that they represent "equivalent risks" is also appropriate, but there must be a specified list of criteria for which this test should be performed, rather than demanding equivalence for "each material characteristic" whether "quantitative" or "categorical."[25]

Requiring that an Auto Sponsor identify an Unsecuritized Pool based on these revised criteria, perform the sampling and testing described above, maintain the assets unsecuritized for the life of the related ABS transaction and service them in the same manner as the securitized assets are serviced are all appropriate conditions that ensure that the selection process was proper, will be respected on an ongoing basis and will expose the Auto Sponsor to a risk that is analogous to exposure to the related ABS. However, the further requirements set forth in the Unsecuritized Pool proposal—demanding an agreed upon procedures report on the selection, testing and maintenance procedures at the time of the ABS sale; requiring monthly testing and reporting of the performance of the Unsecuritized Pool for comparison against the ABS pool—

[25] The Auto Sponsors expect to propose a list of asset-specific criteria for which it would be appropriate to perform such an equivalency test, such as APR, outstanding principal balance and remaining term.

are unnecessarily costly and time consuming. These additional criteria would drive Auto Sponsors away from ever using this method because it would essentially require that they hold an Unsecuritized Pool, unhedged and wholly at their own expense, while simultaneously assuming the most onerous ongoing costs of a securitization with respect to those assets.

Our motor vehicle ABS investor members are not supportive of Unsecuritized Pool risk retention in any form due to concerns that it will be difficult to ensure that any sample of pool assets selected is in fact random and adequately represents the overall credit risk of the assets that are securitized. However, the Auto Sponsors believe that if the rules were modified to allow them to hold an Unsecuritized Pool in the manner described in this section that proper risk alignment could be achieved. And, of course, if an Auto Sponsor proposes to hold risk retention in only this form for a particular securitization but investors desire that other forms (e.g., horizontal risk retention) be added to or replace the Unsecuritized Pool retention, then we expect that the Auto Sponsor would have no choice but to respond to those desires by modifying its proposed form of risk retention so as not to risk losing investors or causing an increase in the securitization's pricing.

*c. "Blended" Risk Retention*

The Auto Sponsors note that the proposal to allow "L-shaped" risk retention (i.e., a combination of a vertical slice and a horizontal slice in a prescribed ratio) acknowledges that it is possible to "mix and match" different forms of risk retention while still ensuring that, in the aggregate, exposures have been retained by the sponsor that equal a full five percent of the ABS interests issued in the securitization. There is no reason that a formula could not be set forth in the final regulations that describes how to value each of a retained "vertical slice," a retained

"horizontal slice," a cash-funded reserve account,[26] an Unsecuritized Pool and, for revolving master trust securitizations of dealer floorplan receivables, a seller's interest, when such exposures are held in combination and in order to achieve an aggregate retained risk exposure of at least five percent.

Allowing this type of flexibility would ensure that sponsors are not required to retain more exposure to their securitizations than the rule intended. For instance, because the Auto Sponsors have, for decades, traditionally retained 100% of the subordinated residual interests in their securitizations, they anticipate that investors will expect that they will continue to hold those interests as horizontal risk retention in almost all cases. If such an Auto Sponsor finds that its subordinated residual interest is only "valued" at approximately 4.5% on a particular transaction, however, then the Auto Sponsor would have to consider transferring additional eligible assets to the asset pool to enhance the value of the ABS interest comprising the horizontal risk retention, despite the fact that those assets are otherwise unnecessary to support the securitization's expected losses and cashflow demands. If the Auto Sponsor does not have additional eligible assets to contribute, the least inefficient way for it to meet its risk retention requirements under the Proposed Regulations would be to also hold approximately 2.5% of the vertical slice of the securitization (which is the minimum amount it would have to hold to satisfy the "L-shaped" risk retention requirement but results in approximately 7.0% risk retention). A more logical solution would be to allow such a sponsor to fund a reserve account, as envisioned by the horizontal slice rules, to make up the approximate 0.5% difference, or to allow it to construct a similarly sized Unsecuritized Pool.

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[26] In the provisions relating to horizontal risk retention, the Proposing Release would permit a sponsor to establish a cash-funded reserve account in the same amount as the required "horizontal slice" rather than structuring and holding that subordinated ABS interest.

In this context it is important to note that not all investors would prefer a horizontal slice, so flexibility in the risk retention options is critical to the ongoing viability of this market. For example, some of our investor members would prefer a vertical slice because they believe horizontal retention may create incentives for the servicer to adopt servicing strategies that benefit the first loss interest over the other tranches if the servicer and the sponsor are affiliated. Other investors may desire that the sponsor be exposed to both forms and would prefer a blend of vertical and horizontal retention, such as that described above.

*d. Maintaining the Retained Exposures*

The Auto Sponsors believe that there is no particular value in mandating that they hold their exposure in the same form throughout the life of a deal.[27] So long as a sponsor (i) discloses in its offering documents the manner in which it is allowed to adjust its risk retention holdings over the life of the securitization, (ii) always maintains a specified minimum level of exposure and (iii) for publicly registered securitizations, reports any material reconfiguration to its risk retention holdings in a Form 8-K filing, it should be allowed to modify its risk retention allocations post-closing. Our investor members believe that disclosure of changes in the retention over time is critical to having a full understanding of a sponsor's interests and risks in the securitization.

Additionally, as is mentioned above in the discussion regarding horizontal risk retention, the Auto Sponsors believe that the risk retention rules are intended to cause a sponsor to maintain a fixed percentage of exposure to a securitization over time rather than a fixed amount of exposure. By way of example, if a sponsor retained $5 of risk against $100 of ABS issued at

[27] For instance, a sponsor might find that the value of the ABS it retained to satisfy horizontal risk retention has increased and that it can therefore securitize the assets that it had been holding on its balance sheet as an Unsecuritized Pool or sell those ABS that it had initially retained for vertical risk retention purposes.

closing, if those ABS had amortized to $50 and no losses had been incurred, the sponsor would be able to hedge, sell or otherwise dispose of half of its retained risk to maintain its five percent level of exposure and would not be required to maintain the full exposure that had come to represent 10% of the ABS interests. In their comments on the Proposing Release the Auto Sponsors intend to request that an explicit acknowledgement of this "step down" mechanism be included in the section relating to transfers and hedging.

***ii. Qualifying Automobile Loan Adjustment***

The Auto Sponsors had initially hoped that the adjustment that would be proposed for securitizations of Qualifying Automobile Loans would allow for regular securitizations in the prime motor vehicle market. ABS that are backed by prime motor vehicle collateral have historically been collateralized and structured to ensure exceptionally strong performance, as illustrated by the fact that investors in these public securitizations have never suffered missed interest payments or principal losses. Furthermore, there have historically been far more ratings upgrades than downgrades as a result of asset performance and conservative transaction structures in the motor vehicle ABS sector.[28] Unfortunately, the Proposed Regulations are drafted so narrowly and with such a focus on underwriting and loan characteristics that (incorrectly) assume a significant overlap between the motor vehicle and residential mortgage markets that they are presently unusable by all Auto Sponsors.

The Auto Sponsors do not currently originate motor vehicle loans using the criteria set forth in the Proposing Release in many significant respects. Furthermore, they indicated that

[28] For example, during the period from January 1, 2001 through December 31, 2010, Standard & Poor's issued 635 upgrades of classes of retail automobile loan ABS, compared to just 37 downgrades for pool credit related reasons (figures exclude downgrades due to the downgrade of a credit support provider, such as a monoline insurer). In addition, no defaults have occurred on any prime automobile retail loan ABS rated by S&P since they began rating automobile ABS in 1985.

they would not customize their origination standards to allow them to assemble such a pool of Qualifying Automobile Loans because the stricter underwriting procedures described would drive away all but the least creditworthy customers;[29] the criteria regarding loan-to-value, debt-to-income and other numeric standards do not comport with their general business models; and any effort to implement a "parallel" origination structure under which qualifying assets could be generated would be so expensive and difficult to administer that its costs would eclipse any possible benefits from lower mandated risk retention.

In short, the Auto Sponsors do not believe that a motor vehicle ABS transaction has ever been executed where the collateral would meet the criteria set forth in the Proposed Regulations or that attempting to originate conforming collateral would be economical for them. Unless the Qualifying Automobile Loan Adjustment is reworked significantly, the Auto Sponsors expect that it will remain wholly unused, despite the clear Congressional intent to foster such an asset class.

*a. Principal Issues with the Qualifying Automobile Loan Adjustment*

The Auto Sponsors believe that in preparing the Qualifying Automobile Loan Adjustment the drafters made a fundamental error in attempting to analogize to the residential mortgage asset class. This inappropriate paralleling is evident in the focus on debt and income verifications at origination, which have traditionally not been required for even the highest quality motor vehicle originations; a required 20% down payment (comprised of cash and/or vehicle trade-in value) in a market where advance rates above 100% are commonplace;[30] and a

[29] More creditworthy borrowers presumably would be able to receive financing from lenders that were following today's standard origination processes and were not attempting to conform to the Qualifying Automobile Loan Adjustment standards by demanding additional documentation.

[30] Motor vehicle loans in the ordinary course also regularly finance taxes, titling fees, ancillary products, service contracts, insurance policies and/or balances refinanced on trade-in vehicles. The Proposed Regulations not only

requirement that the originator or its agent hold the certificate of title on the related loan when one-in-five states require that the consumer, rather than the lender, hold a motor vehicle's certificate of title. Other features, such as the proposed maximum loan terms of 60 months in a market where 72-month lending has been a normal market feature for many years, on both new and used vehicles, simply illustrate a misunderstanding of what constitutes a "standard" product in the motor vehicle marketplace.

Furthermore, the Auto Sponsors believe that the proposed exemption is underinclusive in that it omits many types of consumer transactions that are made using high-quality underwriting standards and that give rise to assets that would be appropriately securitized without prescribed levels of enhancement. For example, in omitting loans to commercial purchasers and to individuals who will use their vehicles for commercial uses by mandating that all loans be made to individuals to secure vehicles used for personal or family use, failing to include motorcycles in the list of permissible "passenger vehicles" and excluding motor vehicle lease transactions, the Proposed Regulations focus on a particular subset of the motor vehicle sector (i.e., loans to individuals for cars) that omits equally creditworthy and low-risk products that should have equivalent access to the exemption.

*b. Alternative Exemption Regime*

The Auto Sponsors believe that the only appropriate way in which a Qualifying Auto Loan Adjustment could be implemented is by focusing on a securitization's entire asset pool based upon weighted averages of specified pool characteristics. As the Auto Sponsors indicated in November 2010, in the ASF Auto Risk Retention Letter to the Joint Regulators, this

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require a minimum 20% down payment but also demand that the consumer pay 100% of the title, tax, registration and dealer-imposed fees.

methodology was previously utilized by the Federal Reserve Bank of New York to determine eligibility for borrowings under the Term Asset-Backed Securities Loan Facility ("TALF") where, for example, weighted average FICO Score was used to distinguish between prime and subprime automobile loans for determining the appropriate haircut levels. Motor vehicle assets are, within their various subclasses (e.g., subprime loan, prime lease), largely homogeneous assets that are short term, not particularly interest rate sensitive, rarely refinanced and collateralized by an asset that is easily and quickly liquidated following repossession. Taken together these characteristics suggest that a focus on loan-by-loan origination characteristics to forecast a securitization asset pool's "creditworthiness" is unnecessary and misguided. We also note that, unlike for the QRM exemption, the mandate in the Dodd-Frank Act to develop a Qualified Automobile Loan Adjustment did not demand that 100% of the assets collateralizing the subject transaction meet particular characteristics, so we believe that our alternative approach is both more appropriate and permissible.

Focusing on pool-wide characteristics would accurately provide an indication of a securitization's overall credit quality. While the Auto Sponsors have not yet formulated specific pool composition criteria, they expect that, after consultation with motor vehicle ABS investors, they will propose that in order to meet the Qualifying Automobile Loan Adjustment the securitizations' underlying asset pool, on a weighted average basis, would be required to meet a variety of criteria, which may include specified loan-to-value, FICO score, original term and new vs. used vehicle standards. They may also conclude after discussions with their investors that it would be appropriate to limit the securitization's exposure to relatively lower quality assets by including maximum pool concentrations at the lower ends of certain of these criteria (for

example, a pool where (1) the assets have a weighted average FICO Score of ___ and (2) no more than ___% of the assets have a FICO Score below _____ ).

If a pool constructed in this manner could satisfy the Qualifying Automobile Loan Adjustment, investors and regulators would be assured that the ABS were of the highest quality and that an exemption from the risk retention requirements would be appropriate.[31] Additionally, this would allow Auto Sponsors to construct conforming securitizations from their regularly originated assets in the same manner as they presently create pools, albeit with a focus on higher quality pool assets.

*c. Investor View*

At this time, our investor members have not developed views around a particular approach for Qualifying Automobile Loans but they intend to provide detailed comments along with the Auto Sponsors in ASF's forthcoming response letter to the Proposed Regulations. The investors' preliminary belief is that a Qualifying Automobile Loan would be the "gold standard" and very high quality. That being said, they do agree that the current proposed definition is likely too restrictive and incorporates criteria, such as the 20% down payment, that are not typically used in the auto space. They also believe that developing an appropriate set of criteria will require a substantial review of historical data to ensure optimal performance.

[31] It should be noted that while the Auto Sponsors are eager to craft a workable Qualified Auto Loan Exemption, they do not expect that their investors or the rating agencies would generally allow them to conduct securitizations in which they truly retained no risk. For instance, as described in Section I.a. above, "horizontal slice" risk retention has been the norm in motor vehicle securitizations for decades and the Auto Sponsors believe that they would retain those exposures even in an exempted transaction (although that exposure might be at less than a five percent level if that lower level is all that a particular securitization's structure mandates).

**C. Asset-Backed Commercial Paper Conduits**

***i. Introduction***

ABCP has for nearly 30 years been a vital source of low-cost working capital for businesses of all kinds both in the United States and globally, from industrial companies to finance and service companies to governmental entities. Assets funded through these vehicles include auto loans, commercial loans, trade receivables, credit card receivables, student loans and many other types of financial assets. ABCP financing of corporate America and the global economy remains substantial. For example, approximately $68 billion of automobile loans and leases, $26 billion of student loans, $34 billion of credit card charges, $41 billion of loans to commercial borrowers and $64 billion of trade receivables were financed by the U.S. ABCP market as of December 31, 2010. The total outstanding amount of ABCP sold in the U.S. market stood at $378 billion as of December 31, 2010. Asset-backed commercial paper conduits with full liquidity support from financial institutions of the type described in the proposed risk retention rule[32] have functioned well, even through the depths of the financial crisis.

While we support risk retention in the context of the ABCP market, the Proposed Regulations would impose unnecessary restrictions that will impede this well-functioning and valuable market. As described below, the sponsors of ABCP conduits already assume well in excess of 5% of the risks of the assets financed in ABCP conduits through credit support facilities. Investors in ABCP conduits, therefore, rely on the credit quality of those sponsors, not

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[32] We note that certain segments of the asset-backed commercial paper markets performed poorly after the onset of the global credit and liquidity crisis. In particular, asset-backed commercial paper issued by "structured investment vehicles" ("SIVs") and other non-bank supported market value financing platforms, including market value CDOs, were unable to satisfy their liquidity needs or issue additional short-term securities from the onset of the credit crunch, and were thereafter effectively shut out of the short-term capital markets. These types of vehicles would not qualify for the treatment that we are proposing today and we agree with the joint regulators that these types of vehicles should not be eligible for the risk retention options available to eligible asset-backed commercial paper conduits.

on the assets purchased by ABCP conduits. Imposing additional risk retention requirements at the asset level would not advance the purposes of Dodd-Frank. Indeed, because ABCP investors rely on the credit of the sponsor and not the assets in the conduit, we do not believe that ABCP is an asset-backed security under Dodd-Frank. Moreover, we believe that most ABCP conduit sponsors are not securitizers subject to Dodd-Frank because they don't transfer assets to an issuer of asset-backed securities. In addition, for sponsors that cannot rely on credit support facilities to satisfy risk retention, there are a number of provisions in the rule that are unworkable and inconsistent with market practice, without furthering the purposes of the Proposed Regulations. Finally, as described below, investors in ABCP seek and receive detailed disclosure about the conduit, its sponsor and the assets in the conduit. Any additional requirement to disclose the names of originator-sellers would not be welcomed by investors in ABCP and would not serve the purposes of the rule.

***ii. Lack of Statutory Authority to Impose Risk Retention Requirements on ABCP and ABCP Conduit Sponsors***

At the outset, we note that the Joint Regulators would appear to lack statutory authority to impose risk retention requirements on ABCP and most ABCP conduit sponsors. Section 941(b) of the Dodd-Frank Act only mandates the Joint Regulators to prescribe risk retention requirements to "securitizers" that issue "asset-backed securities" as each such term is defined in the Dodd-Frank Act. Consistent with that mandate, the base risk retention requirement in the Proposed Regulations requires sponsors of transactions "involving the offer and sale of asset-backed securities" to retain an economic interest in the securitized assets.

As we indicated in the ASF ABCP Risk Retention Letter submitted to the Joint Regulators on November 22, 2010,[33] the term "securitizer" is defined in the Dodd-Frank Act as, generally, the issuer of an asset-backed security or a person who organizes an asset-backed security by transferring assets to an issuer. Similarly, the term "sponsor" is defined in the proposed risk retention rule as "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." Most ABCP conduit sponsors, particularly sponsors of multi-seller conduits, do not transfer assets to the ABCP conduits they sponsor and thus are neither securitizers nor sponsors.

In addition, "asset-backed security" is defined in the Dodd-Frank Act as a security that entitles its holder to receive payments that depend primarily on cash flow from self-liquidating financial assets. As further described below, payments on assets financed by ABCP conduits are not expected to be the source of payments made to ABCP investors. Instead, it is expected that ABCP investors will be paid either from proceeds generated through the issuance of additional ABCP notes or, if ABCP cannot be successfully offered on such day, through draws on the liquidity and credit support facilities provided by regulated financial institutions. ABCP therefore does not meet the definition of "asset-backed security" in the Securities Exchange Act of 1934 and therefore should not be subject to the proposed risk retention rule.[34]

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[33] *See* "ASF Comment Letter re Risk Retention for ABCP," American Securitization Forum (November 22, 2010), available at http://www.americansecuritization.com/uploadedFiles/ASF_ABCP_Risk_Retention_Comment_Letter_11.22.10.pdf.

[34] In addition, we note that the term "asset-backed security" as defined in the Dodd-Frank Act includes within it the term "security" as that term is separately defined in Section 3(a)(10) of the Securities Exchange Act of 1934. By operation of those definitions, if a note is not a security under Section 3(a)(10), then it is not an asset-backed security under Section 3(a)(77).

The definition of security in Section 3(a)(10) of the Exchange Act excludes "any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months,

***iii. Unique Features of ABCP Conduits; Investors Rely on Credit of Support Providers and Quality of Program***

ABCP is unique and functions differently from other securitization products. In most securitization transactions, the quality and performance of the assets financed directly translates to the quality of the securities issued by the securitization issuer. If the financed assets perform well, the securities will perform well; if the assets perform poorly, the performance of the securities will suffer. However, ABCP conduits are designed to issue commercial paper that is supported by credit and liquidity facilities provided by a bank or other financial institution. In fact, an overwhelming majority of ABCP conduits are covered by letters of credit, revolving credit commitments and other support facilities from their sponsors that absorb credit losses on the assets financed by ABCP conduits before the ABCP investors absorb any losses. We refer to these types of credit enhancement as Program Support Facilities. ABCP conduit sponsors undertake substantial diligence in underwriting customer transactions in determining whether to provide those Program Support Facilities. Accordingly, ABCP investors do not primarily base their investment decisions on the credit quality of the assets that collateralize transactions in the conduits. Instead, ABCP investors focus on (i) the creditworthiness of the financial institution that provides liquidity and credit support to the conduit issuer of the ABCP, (ii) the circumstances under which liquidity and credit support facilities may be drawn, (iii) the circumstances in which the conduit may be prohibited from issuing ABCP - in which case the asset performance risk shifts to the liquidity and credit support providers who are required to repay the maturing ABCP, and (iv) the experience and operational capability of the sponsor of

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exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited" (emphasis supplied). Therefore, there is support for the proposition that ABCP issued with initial maturities of 270 or fewer days is not a "security" for this purpose and therefore is not an "asset-backed security."

the ABCP conduit. Most of these protections are not present in other types of securitized products.

Our members, both issuers and investors, believe that the purposes of the risk retention provisions of the Dodd-Frank Act would not be served by imposing additional risk retention obligations on sponsors who already provide Program Support Facilities or on the customers of the ABCP conduits they sponsor. Sponsors of these ABCP conduits already assume the risks of assets financed by ABCP conduits well in excess of 5% of the amount of those assets. In particular, no case has been made that incentives were not well-aligned between and among issuers of and investors in ABCP through the recent crises. We are not aware of any losses by holders of fully supported ABCP, even in the worst U.S. economic downturn since the Great Depression. Unfortunately, the Proposed Regulations don't appear to have accounted for these views, but instead posit misaligned incentives without demonstrating where or how that misalignment exists. If the Proposed Regulations are finalized into rules as currently written, appreciable reductions in ABCP lending volumes would result, ultimately causing the further deterioration of the availability of credit to American businesses. If, notwithstanding these concerns, Congress chooses to include ABCP in the Proposed Regulations by amending the definitions of "asset-backed security" and "securitizer" as currently defined in the Dodd-Frank Act, so as to subject ABCP and ABCP program sponsors to the Proposed Regulations, the following modifications to the Proposed Regulations would be appropriate.

***iv. Sponsor-Provided Program Support Facilities***

The commentary to the Proposed Regulations states that ABCP conduit sponsors may satisfy risk retention through one of the other non-ABCP-specific risk retention options. Program Support Facilities traditionally provided by the sponsors of ABCP conduits, however,

are not specifically covered by name in any of the categories of permitted risk retention. This is striking for two reasons: first, because of the prevalence of these facilities as a form of sponsor support to ABCP programs, and, second, because the recently adopted European risk retention rules applicable to banks explicitly treat these Program Support Facilities as adequate risk retention.[35] Because of the substantial support provided by these facilities and the reliance that ABCP investors place on this support and the substantial economic risk taken by the ABCP sponsor through its provision of such support, we believe a sponsor-provided Program Support Facility that absorbs at least 5% of credit losses before the ABCP holders absorb any such losses (e.g., through a subordinated letter of credit or otherwise) should be specifically identified in the final risk retention rule as an adequate form of risk retention.

We note that in many instances these facilities take the form of letters of credit or other similar undrawn credit facilities. The fact that these facilities are not initially funded positions should not, in our view, preclude their use as permissible forms of risk retention. The institutions providing these facilities have in the past and fully expect in the future to honor their funding obligations when required to pay ABCP. The interests of these institutions are therefore fully aligned with the investors in ABCP and as discussed elsewhere herein they have every incentive to assure that the transactions financed by the ABCP conduits they sponsor are well underwritten. We also note that in recognition of the potential risks taken by these facilities, banks that provide them are required to maintain capital against them as if they were funded securitization positions from the date of their issuance.

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[35] *See* Committee of European Banking Supervisors, *31 December 2010 Guidelines to Article 122a of the Capital Requirement Directive*, paragraph 57.

***v. Eligibility Requirements for ABCP Conduits and Other Requirements of the Proposed Regulations***

If the risk retention rules are ultimately applied to ABCP conduit sponsors, we believe that the special option provided for such sponsors in the Proposed Regulations is an important alternative for sponsors that cannot rely upon Program Support Facilities to satisfy any such risk retention requirement. We support the Joint Regulators' attempt to define the parameters for an eligible ABCP conduit and agree that only conduits meeting appropriate special requirements should have the benefit of conduit-specific risk retention options. We believe that most of the special eligibility requirements set forth in the Proposed Regulations are appropriate and effectively promote the goal of protecting investors in these vehicles who depend on the quality of the program and its sponsor. These include requirements that the sponsor of the ABCP conduit approve each originator-seller financing assets in the conduit; establish asset criteria; approve all investments; monitor the assets and the borrowers; and ensure compliance with the conduits' credit and investment policies. The structural requirements that the issuing vehicle be isolated from the risk of bankruptcy of the originator-sellers and that the issuer have the benefit of 100% liquidity coverage from a regulated liquidity provider are also sound and consistent with current market practice.

We believe, however, that some of the requirements of the Proposed Regulations are unworkable and inconsistent with established market practice, and that imposing these requirements would reduce financing options available to U.S. companies without furthering the purposes of the Proposed Regulations. In particular, if an ABCP conduit sponsor seeks to rely on originator-seller risk retention in order to comply with the Proposed Regulations, the only permitted form of such risk retention is the originator-seller's retention of a horizontal residual

interest. As described above, ABCP conduits currently fund a wide variety of assets. While many of those transactions are structured with originator-seller horizontal risk retention, many transactions are structured in a manner that would satisfy one of the other general risk retention methods described in the Proposed Regulations. We see no policy reason why those risk retention methods should not be available for transactions that are funded with ABCP. As stated elsewhere in this testimony, sponsors of ABCP conduits and their support providers have substantial incentives to assure that the amount and type of risk retention for transactions financed by these conduits are significant.

There are also a number of other technical requirements of the Proposed Regulations that could restrict ABCP conduits from investing in transactions that would otherwise be acceptable investments for eligible ABCP conduits under the Proposed Regulations. For example, the requirement that the interests of an SPV selling assets to a conduit consist only of retained interests and interests sold to an ABCP conduit does not take into account that in many cases an issuer may also sell interests to other third parties. As an illustration, an ABCP conduit might purchase a security issued by a credit card master trust that issues different series of securities to various investors. So long as the ABCP conduit separately negotiates the terms of each purchase, we see no reason this long established practice should be prohibited. In addition, the requirement that the interests issued by the intermediate SPV be collateralized solely by assets from a single originator would preclude investment in an SPV backed by assets originated by more than one affiliated originator. We see no useful policy goal in so limiting the investments that eligible conduits can make. We will recommend changes to the final rule to address these and other technical issues in our comment letter to the Joint Regulators.

***vi. Disclosure***

Consistent with the disclosure requirements for other forms of sponsor-provided risk retention, sponsors using Program Support Facilities as a permissible form of risk retention expect to disclose the pertinent details of the form, amount and nature of such facilities to ABCP investors and potential investors that would rely on such retention. Such disclosure should be in the form the proposed risk retention rule requires for liquidity facilities.

For those ABCP conduits that would rely upon the special originator-seller risk retention option provided for in the Proposed Regulations, we believe that disclosure of the names of those originator-sellers as would be required by the Proposed Regulations is unnecessary, and may be counterproductive. ABCP investors do not have credit recourse to originator-sellers of financed assets, and so, appropriately, do not make their investment decisions based on the names of the originator-sellers, but on the creditworthiness and capability of the sponsor and the credit quality of the financed assets. Referencing the names of the originator-sellers may in fact be misleading, or at least inappropriate, as investors may inadvertently be led to believe that they have some credit recourse to such originator-sellers. We also believe that disclosure of this information is unnecessary under the terms of the Proposed Regulations. Moreover, the policy goals of the prop Proposed Regulations that such disclosures are intended to promote are satisfied in our view by the proposed disclosure in respect of the sponsor and its liquidity and credit support providers.

Because ABCP is continuously offered and generally matures within a very short time frame, ABCP investors are continuously evaluating the merits of one ABCP program versus another and versus other alternative investments. Components of this evaluation are the relative experience of the program's sponsor and the relative strength of the program and of its liquidity and credit support providers. To assess this, ABCP investors require continuous and ongoing

information about the liquidity and credit support providers, which is available to investors through current public filings made by such parties and news services that continuously report on the business affairs and credit quality of these parties.

The market has been very efficient without regulatory oversight in demanding and eliciting information regarding the performance of the ABCP programs and their underlying assets. Information provided periodically to investors has included: (1) the program purchase limits, the aggregate amount of outstanding ABCP, the aggregate amount of commitments, and the number of asset pools; (2) information on program assets by asset type, industry and financed asset purchase limits and default statistics; (3) any program-wide events of default and draws on program support facilities; and (4) the names of all liquidity and credit support providers. Accordingly, because the information provided to ABCP investors reflects the unique characteristics of the related ABCP program, and have been developed by ABCP conduits (or their sponsors) over time so as to be consistent with ABCP investor demands, we (including, without exception, our investor members) believe such information reporting is appropriate and sufficient for ABCP programs.

In connection with proposed changes to Regulation AB, the ASF ABCP Conduit Subforum and ASF ABCP Investor Subcommittee recently worked together to develop a detailed comment letter[36] proposing uniform information reporting standards for ABCP conduits. Our members continue to support such proposed reporting requirements, which do not require the disclosure of originator-seller names, as would be required by the Proposed Regulations.

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[36] *See* ASF Comment Letter re ABCP under Regulation AB II: <http://www.americansecuritization.com/uploadedFiles/ASFRegABIIABCPCommentLetter8.2.10.pdf>.

We fully appreciate the need for disclosure in private transactions that enables investors to make informed decisions about the investments they are considering for purchase and informed analyses about the investments they own. We are confident that sponsors of ABCP conduits currently provide investors and potential investors in ABCP the information that such investors require and deem relevant.

### D. Credit and Charge Card ABS

#### *i. Risk Retention for Credit and Charge Card ABS Generally*

The first securitization of credit card receivables was completed in 1987. The master trust structure was introduced shortly thereafter to accommodate the revolving nature of credit and charge card receivables. Since that time, the master trust structure has been the primary source of financing for unsecured revolving consumer credit in the United States, and credit and charge card ABS performance has been consistently strong, even during the recent financial crisis.

The master trust structure is equipped with numerous technical features that have allowed issuers to respond to changing market conditions. Long before "skin in the game" became a topic of political debate, credit and charge card issuers were holding seller's interests and retaining other meaningful interests in their master trusts that align the interests of issuers with the interests of investors. Features of the credit and charge card ABS market that have facilitated this alignment include:

1. the seller's (or transferor's) interest;
2. the seller's right to receive finance charge collections that remain after covering payments, losses and other amounts allocated to investors (excess spread);
3. the originator's continued ownership of the account (even though the receivables have been transferred to the master trust);
4. the originator's continuing credit-granting and underwriting responsibilities as the account owner;
5. the retention of servicing responsibilities for the securitized receivables, in most cases by the credit and charge card originator or an affiliate; and
6. the retention of subordinated tranches or other residual interests (such as reserve accounts) in the master trust.

These risk retention mechanisms have produced significant economic exposures to the securitized assets. Excess spread, for example, represents the securitizer's return on its investment in the securitized assets and is the first interest to absorb losses. The consistent performance of credit and charge card ABS, particularly during the recent credit crisis, evidences the effectiveness of these risk retention mechanisms.

In order to preserve securitization as a viable funding option for credit and charge card issuers, it is critical that the risk retention rules be appropriately tailored to reflect the nuanced and technical features of the master trust structure, and that the master trust structure retains the flexibility to evolve to meet changing investor demands. Failure to achieve these results will significantly increase the cost of capital to credit and charge card issuers, thereby restricting access to, and increasing the cost of, credit to consumers.

***ii. Seller's Interest***

*a. Definition*

The ASF agrees that a range of risk retention options should be available for credit and charge card securitizations, but the "seller's interest" as currently utilized in revolving asset master trust securitizations is the most critical form of risk retention for the market as it exists today. The seller's interest is a quintessential form of credit risk retention that operates to align the economic interests of securitizers with the interests of investors. The Proposed Regulations indicates that the definition of seller's interest is intended to be consistent with current market practices. However, this definition and the related provisions are not entirely consistent with current market practices. Many of our comments are intended to align the seller's interest mechanism under the Proposed Regulations with current market practices.

First, while the allocation of collections and losses is pro rata during revolving periods, the program documents for virtually all credit and charge card securitization transactions fix the allocation of collections to investors, or in some cases even subordinate amounts allocable to the seller's interest to the investor interests during other periods. These mechanisms are intended to provide for the orderly and timely payment of the investor interests. As a result, the definition of seller's interest should be modified to provide that the seller's interest may be pari passu with "*or subordinated to*" the other ABS interests issued by the issuing entity.

Second, under the Proposed Regulations, the sponsor is required to retain a seller's interest of not less than 5% of the principal balance of all of the assets in the revolving asset master trust at the closing of the securitization transaction and until all ABS interests in the issuing entity are paid in full. We have the following concerns with this standard:

1. It is not consistent with the standard for meeting the minimum seller's interest requirement for credit and charge card ABS master trust issuers that measure the seller's interest by reference to the outstanding investor interests rather than the total assets of the master trust.
2. Regulatory efforts to align the interests of a securitizer with the interests of investors should require the securitizer to retain the required seller's interest only until the ABS interests held by unaffiliated third parties are paid in full.
3. In a revolving asset master trust, the seller's interest and the investor interests will change over time to reflect the then-current amount of investor interests and receivables outstanding. As a result, the Proposed Regulations should be clarified to specify that the seller's interest is to be measured as of a current point in time (rather than an earlier point in time, such as the date of issuance of an ABS interest).

To achieve these objectives, the Proposed Regulations should be modified to require securitizers to retain a seller's interest, at the closing of the securitization transaction and until all ABS interests *held by unaffiliated third parties* are paid in full, of at least 5% *of the principal balance of all ABS interests held by investors at that time*.

Finally, under current market practice, if the amount of the seller's interest is reduced below a minimum level established under the securitization documents, certain amounts to be paid to the holder of the seller's interest are instead deposited in an excess funding or special funding account that supports the outstanding ABS interests other than the seller's interest (much like the horizontal cash reserve account described in the Proposed Regulations). For purposes of determining the amount of risk retained by the securitizer under the Proposed Regulations,

amounts in these excess funding or special funding accounts should be included when measuring the amount of the seller's interest.

*b. Who Retains the Seller's Interest*

The Proposed Regulations requires that the seller's interest be retained by the sponsor. The sponsor is defined as "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." In many credit and charge card securitization transactions, the sponsor sells or transfers receivables to an affiliated depositor that, in turn, transfers the receivables to the master trust. In these cases, the seller's interest is held by the depositor rather than by the sponsor. The Proposed Regulations should be clarified to indicate that the seller's interest (or any other form of risk retention) may be held directly by the depositor initially and at any time thereafter, rather than initially by the sponsor with assignment to the depositor thereafter. This is consistent with Dodd-Frank's definition of "securitizer" that includes both the sponsor and the depositor.

***iii. Additional Forms of Risk Retention in Credit and Charge Card ABS***

Unlike amortizing securitization structures, revolving asset master trusts are structured to issue ABS interests in different series at different times. Credit and charge card securitizers believe that the proposal should be revised to allow greater flexibility to combine different forms of risk retention in a securitization, particularly revolving asset master trust securitizations,[37] and revised to modify the manner in which the exposures are held over time, which would achieve the goals of risk retention while reflecting the current structures of their transactions and investors' preferences.

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[37] This is particularly important for a revolving asset master trust, since ABS interests are issued in different series at different times and may be issued with different capital structures.

In addition, in many cases, particularly in the current distressed capital markets, the credit or charge card securitizer or an affiliate retains the most subordinate tranche of the transaction. These subordinate tranches are structured to absorb credit losses before more senior tranches held by third parties are affected and are sized based on the amount of subordination needed to protect more senior tranches from multiples of expected losses. Under the proposed definition of "eligible horizontal residual interest," an ABS interest must have the *most* subordinated claim to payments of both principal and interest. However, there may be additional residual interests (e.g., excess spread or reserve accounts) that should not disqualify other retained subordinated interests from being eligible horizontal residual interests.

***iv. Premium Capture Cash Reserve Account***

The premium capture cash reserve account mechanism should take into account the unique features of a revolving asset master trust. In particular, Section __.12(a)(2)(i) of the Proposed Regulations measures the positive difference between the gross proceeds received by the sponsor at the closing of the securitization transaction and 95% of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction. In the case of a revolving asset master trust, an ABS interest issued at any particular time may be supported by ABS interests (e.g., seller's interest or eligible horizontal residual interests) that are issued at different times. As a result, the rule should include instructions on how the premium capture cash reserve account operates in the context of a revolving asset master trust.

**E. Student Loan ABS**

Student loans have traditionally fallen into the following two categories: (i) student loans originated under the Federal Family Education Loan Program under Title IV of the Higher

Education Act ("FFELP") which, in effect, carry a guarantee by the federal government, and (ii) non-government guaranteed private student loans which typically supplement the federal student loan programs.

***i. Exemption for FFELP ABS***

Established in 1965, FFELP provided for the origination of loans pursuant to minimum prescribed criteria to "qualified students" who are enrolled in eligible institutions, or to parents of dependent students, to finance their educational costs. A "qualified student" is an individual who is a U.S. citizen, national or permanent resident; has been accepted for enrollment or is enrolled and is maintaining satisfactory academic progress at a participating educational institution; is carrying at least one-half of the normal full-time academic workload for the course of study the student is pursuing; and meets the financial need requirements for the particular loan program. In addition, federally insured consolidation loans have been originated for FFELP borrowers following the completion of their education. Loans originated under FFELP were administered by state-level guarantee agencies and reinsured by the federal government. FFELP loans were originated by commercial banks, thrifts, nonprofit organizations, independent finance companies, and credit unions, and were often held in an investment portfolio or securitized.

The Proposed Regulations do not include an exemption for FFELP loan securitizations from the risk retention requirements. Instead, Proposed § __.21(b)(1) fully exempts any securitization transaction if the asset-backed securities issued in the transaction are collateralized solely (excluding cash and cash equivalents) by assets that are fully insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States. As

noted above, FFELP permitted eligible lenders[38] to originate loans that were reinsured by the federal government. Under FFELP, federally insured loans provided a guaranty of 97 to 100 percent of the defaulted principal and accrued interest (in accordance with statutory requirements) in the event that the student defaulted on the loan,[39] so long as the loan was serviced in accordance with Department of Education guidelines.[40] We believe that this reinsurance by the federal government, even though it is limited to 97 or 98 percent of the defaulted principal and accrued interest for some loans, warrants an exemption for FFELP loan securitizations from the risk retention requirements. As noted in the Proposing Release, part of the justification for the exemption of FFELP loan securitizations is that the "federal department or agency issuing, insuring or guaranteeing the ABS or collateral would monitor the quality of the assets securitized, consistent with the relevant statutory authority."[41] Through the reinsurance program administered by the Department of Education, that is certainly the case.

If the Joint Regulators do not believe that a general class exemption for FFELP loans in the Regulations (as ultimately adopted) is warranted, an exemption would also be appropriate under Section 941(c)(1)(B)(ii) of Dodd-Frank due to their negligible credit risk.[42] That section provides for a downward adjustment of the five percent risk retention requirement if prescribed underwriting criteria are met "that specify the terms, conditions, and characteristics of a loan

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[38] As defined under the *Higher Education Act of 1965*.
[39] In addition to borrower default, FFELP provides for the same guaranty against the death, bankruptcy or permanent, total disability of the borrower; closing of the borrower's school prior to the end of the academic period; false certification by the borrower's school of his eligibility for the loan; and an unpaid school refund.
[40] The federally mandated guaranty has decreased slightly over time. Currently, the required guaranty percent of the principal and accrued interest is as follows: 100% for loans initially disbursed before October 1, 1993; 98% for loans initially disbursed between October 1, 1993 and July 1, 2006; and 97% for loans initially disbursed on or after July 1, 2006.
[41] See page 188 of the Proposing Release.
[42] We also note that a more general exemption is set forth under Section 941(c)(1)(G)(i), which requires that the regulations provide for "a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors."

within the asset class that indicate a low credit risk with respect to the loan." While this adjustment provision is meant to prescribe specific underwriting that indicates a low credit risk, we point out that the explicit guaranty of FFELP loans as a result of the federal government's reinsurance substantially insulates the ABS from any material credit performance issues. We also note that implementing risk retention requirements on outstanding FFELP loans, which complied with government-specified parameters in the first place (and were not subjected to commercial underwriting standards), will not impact future underwriting standards for this product as FFELP was eliminated as of July 2010 under the Health Care and Education Reconciliation Act of 2010. Although ASF supports Dodd-Frank's goal of encouraging sound underwriting decisions by improving the alignment of interests among sponsors of securitizations, originators of loans and investors in ABS, this goal would not be served by requiring risk retention in FFELP transactions. We believe an adjustment down to zero could be appropriate given these special circumstances.[43]

Numerous state agencies and various banks and finance companies continue to hold outstanding FFELP loans on their balance sheets. Requiring securitizers of FFELP loans to retain risk would make securitization a less attractive option and these loans would be more likely to remain on the balance sheets of these institutions, invariably tying up significant amounts of capital that could otherwise be extended in the form of private loans or other forms of financial assistance to students. As noted in the Federal Reserve Study, "[M]any financial institutions hold significant legacy portfolios of FFELP loans, and some still sell these loans to each other. Risk retention requirements may damp these whole loan sales if it becomes more

[43] Alternatively, the risk retention requirement could be measured against the uninsured portion of the FFELP loans collateralizing the securitization, so, for example, the risk retention required could equal five percent of three percent of the aggregate principal balance of the collateral, assuming a pool of FFELP loans that were reinsured at 97% of the initially disbursed amount.

costly to finance these loans via securitization."[44] With respect to state and nonprofit agencies, programs awarding grants and other forms of financial assistance for students will receive a boost from new capital. In addition, outstanding FFELP securitizations have recently been subjected to restructurings and new issuances of FFELP backed student loan ABS. Finally and perhaps most significantly, our members, including both issuers and sponsors of student loan backed securitizations and the investors who purchase the student loan ABS that are issued thereby, uniformly and wholeheartedly support a general class exemption from the risk retention rules for FFELP loan securitizations.

***ii. Risk Retention for Private Student Loans***

As discussed in the ASF Comment Letter re Risk Retention for Student Loan ABS, the securitizer (or an affiliate) of a private student loan securitization generally retains ownership of the first-loss piece of the transaction. The first-loss piece is an equity ownership or debt interest in an issuing entity that is subordinated to all tranches of issued ABS and represents the right to receive cashflow at the most subordinated level of the flow of funds. We believe that this form of "horizontal slice" risk retention, which has been utilized in past private student loan securitizations, is effective in aligning incentives between securitizers and investors, due, in large part, to the amount of credit risk to which such interest is exposed. A securitizer holding a "horizontal slice" in the form of a subordinated residual interest is further motivated to structure and service a securitization properly because doing so maximizes the value of its retained interest. Our student loan ABS sponsor members have indicated to us that their future transactions would likely employ the "eligible horizontal residual interest" form of risk retention set forth in the Proposing Release, although some have indicated that future structures may

[44] *See* Federal Reserve Study at page 79.

employ other forms of risk retention included in the Proposed Regulations. Thus, we strongly support the proposed menu of risk retention structures that are included in the Proposed Regulations as appropriate for student loan backed ABS.

**F. Municipal Bond Repackagings**

We believe that another type of securitization that should be fully exempted from the risk retention requirements is any securitization involving the repackaging of municipal bonds, *i.e.*, any securitization transaction if the asset-backed securities issued in the transaction are collateralized by obligations of states, political subdivisions of states or other local governmental entities.

The most common form of such municipal bonds repackaging is often referred to in the marketplace as "tender option bonds" or "TOBs." A typical TOBs transaction consists of the deposit of a single issue of highly rated, long-term municipal bonds in a trust and the issuance by the trust of two classes of securities: a floating rate, puttable security (the "floaters"), and an inverse floating rate security (the "residual"). No tranching is involved. The holders of floaters have the right, generally on a daily or weekly basis, to put the floaters for purchase at par, which put right is supported by a liquidity facility delivered by a highly rated provider and causes the floaters to be a short-term security. The floaters are in large part purchased and held by money market mutual funds. The residual is held by a longer term investor (bank, insurance company, mutual fund, hedge fund, etc.). The residual investors take all of the market and structural risk related to the TOBs structure, with the floaters investors only taking limited, well-defined insolvency and default risks associated with the underlying municipal bonds, which risks are equivalent to those associated with investing in such municipal bonds directly.

The TOBs market, which has been in existence for nearly two decades, has come to play an important role in the larger municipal finance market by bringing together issuers of fixed rate, long-term debt and buyers of variable rate, short-term instruments. While, as noted above, in many respects the risks associated with owning floaters are no different than those associated with owning the underlying municipal bonds directly, the critical difference is that such municipal bonds would likely not be eligible investments for most money market mutual funds and other floaters investors. It is noteworthy that no abuses in regard to the risk profile or return on investment were identified in connection with TOBs programs during the recent market disruptions. Indeed, the largely unfettered right to put the floaters, for any reason, to the liquidity provider, whether for reasons related to the performance of the underlying assets or for market reasons, is a distinguishing feature of the TOBs structure.

Proposed Section __.21(a)(3) provides an exemption from the risk retention requirements for any asset-backed security that is a security issued or guaranteed by any state of the United States, by any political subdivision of a state or territory or by any public instrumentality of a state or territory that is exempt from the registration requirements of the Securities Act. We believe that Section __.21 should be expanded to provide an exemption from the risk retention requirements for any securitization that is collateralized solely (excluding cash and cash equivalents) by a security that is, or securities that are, of the type described in Section __.21(a)(3).

We believe that such exemption from the risk retention requirements for municipal bonds repackaging transactions is appropriate in the public interest and for the protection of investors as contemplated by Section 15G(e)(1)(G)(i) of the Exchange Act. We offer the following three rationales for such belief.

First, we refer to the treatment of obligations of the United States and agencies of the United States under the Proposed Regulations. Specifically, proposed Section __.21(b) fully exempts any securitization transaction if the asset-backed securities issued in the transaction are either collateralized by obligations issued by such federal entities, collateralized by assets secured as to payment by such federal entities or themselves guaranteed as to payment by such federal entities. The commentary states that such exemption is supported by the fact that the "federal department or agency issuing, insuring or guaranteeing the ABS or collateral would monitor the quality of the assets securitized." The commentary uses similar language in support of the exemption for municipal obligations pursuant to Section __.21(a)(3) described above, noting "the role of the State or municipal entity in issuing, insuring, or guaranteeing the ABS or collateral." We assert that this exemption for municipal obligations is under-inclusive. Specifically, we believe that the same rationale which underlies the exemption for any securitization with collateral issued, insured or guaranteed by the United States or any agency of the United States supports the exemption from the risk retention requirements for any securitization that is collateralized solely by obligations of state or local governmental entities.

Second, we assert that municipal bonds repackaging securitizations are not the type of securitizations that prompted Congress to enact Section 15G. Indeed, municipal bonds repackaging transactions are not perceived in the marketplace as being asset-based securitizations at all. This point was made by several market participants in August 2010 in response to the Commission's proposed rule with respect to asset-backed securities, including the revision of Regulation AB under the Securities Act and the Exchange Act.[45] The

[45] *See* Regulation AB Comment Letters by Bank of America (August 2, 2010), available at http://www.sec.gov/comments/s7-08-10/s70810-108.pdf, and JPMorgan Chase & Co. (August 2, 2010), available at http://www.sec.gov/comments/s7-08-10/s70810-110.pdf.

Commission has tacitly acknowledged that asset-based securities with assets consisting of municipal obligations are different from other asset-backed securities. *See, e.g.*, Rule 2a-7 under the Investment Company Act (distinguishing "Conduit Securities" and "Government Securities" in several places).

Third, we emphasize the vital connection between the municipal bonds repackaging market, particularly the TOBs market, and the greater municipal finance market, *i.e.*, bringing together long-term state and local governmental issuers and short-term investors, mentioned above. Imposing the risk retention requirements on these securitization transactions likely would cause fewer of these securitization transactions to be done. This reduction of access to the short-term market will reduce the liquidity of municipal bonds, which will lead to an increase in the borrowing costs for municipalities and other issuers of municipal bonds, all at a time when many state and local governmental entities are in serious need of cash for important public projects and essential governmental activities. Correspondingly, there will be decrease in short-term investments available for the tax-exempt money market funds, which have become a key component of the investment portfolios of individuals of all income brackets, which is particularly problematic in light of the recent changes to Rule 2a-7 regarding daily and weekly liquidity requirements. All this would occur with little or no apparent benefit to market participants.

**G. Corporate Debt Repackagings**

Corporate debt repackagings ("Corporate Debt Repackagings") are created by the deposit of corporate debt securities purchased by the sponsoring institution in the secondary market into a trust which issues certificates backed by cash flows on the underlying corporate bonds. Corporate Debt Repackagings are generally issued in order to (i) provide access by individual investors to the corporate debt market through the offering of trust certificates having minimum denominations lower than those typically associated with the underlying security or (ii) allow corporate debt to be combined with interest rate or currency swaps in order to provide institutional investors with a preference for floating rate instruments the opportunity to invest in corporate debt having a fixed interest rate, to allow institutional investors with a preference for fixed rate instruments the opportunity to invest in corporate debt having a floating interest rate or to allow institutional investors to receive payments in currencies other than the currency in which the underlying corporate debt securities are denominated. Institutional transactions generally involve a small number of investors and are tailored to meet the investment objectives of the particular investors.

Corporate Debt Repackagings are commonly issued as registered securities under existing Form S-3 and, to the extent that the debt of a single issuer or a group of affiliated issuers of the underlying corporate debt securities represents 10% or more of the asset pool, unless the pool assets are backed by the full faith and credit of the United States, the financial information required by Item 1112 of Regulation AB is provided to investors in the trust certificates, generally through incorporation by reference as contemplated in Item 1100(c)(1) of Regulation AB or by reference as contemplated in Item 1100(c)(2) of Regulation AB. Corporate Debt Repackagings are also offered privately in reliance on Rule 144A under the Securities Act,

generally to customers of the sponsor who indicate, through reverse inquiry, that they hold corporate debt securities with payment characteristics that they would like to change through the addition of swaps, as described in the preceding paragraph.

Corporate Debt Repackagings are generally considered asset-backed securities and are, therefore, likely encompassed within the broader definition of Exchange Act ABS added by the Dodd-Frank Act. Therefore, on its face, Section 941 of the Dodd-Frank Act would, in the first instance, require the Joint Regulators to prescribe regulations requiring a securitizer of corporate debt securities to retain an economic interest in a portion of the credit risk for those assets. However, Section 941 of the Dodd-Frank Act permits the Joint Regulators to provide for a total or partial exemption of any securitization, "as may be appropriate in the public interest and for the protection of investors" and further grants the Joint Regulators the power to "jointly adopt or issue exemptions, exceptions or adjustments to the rules issued under this section, including exemptions, exceptions or adjustments for classes of institutions *or assets* (emphasis added) relating to the risk retention requirement..." Section 941 further provides any exemption, exceptions or adjustment adopted by the Joint Regulators "shall (A) help insure high quality underwriting standards for the securitizers and the originators of assets that are securitized or available for securitization; and (B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers in businesses to credit unreasonable terms, or otherwise be in the public interest and for the protection of investors."

Both the risk retention requirement of Section 941 and the language permitting exemptions from the risk retention requirement and setting forth the standards for exemption reflect the fundamental legislative intent behind Section 941. Specifically, in adopting the risk retention requirement of Section 941, as well as the other provisions of subtitle D of the Dodd-

Frank Act relating to improvements to the asset-backed securitization process, Congress sought to address what it perceived as flaws in the securitization process that contributed to or precipitated the recent financial crisis. Chief among these was the perceived deterioration in credit underwriting standards, particularly in the residential mortgage market, as a result of the transfer of ownership to capital markets investors, through securitization, of newly originated assets which, prior to the advent of securitization, had traditionally been held in the portfolio of the asset originator or purchased by institutional whole loan purchasers who performed thorough due diligence. Therefore, it has been suggested, the separation of loan origination and ownership reduces the traditional incentives for asset originators to ensure that the assets they originate are of high quality. The expansion of the definition of asset-backed security to include collateralized debt obligations, collateralized bond obligations, collateralized debt obligations of asset-backed securities and collateralized debt obligations of collateralized debt obligations, reflects the legislative understanding that the existence of so-called "second generation" securitizations, i.e. securitizations of previously issued interests in other securitizations, may have helped to exacerbate the deleterious effects of separation of loan origination and loan ownership.

To address the perceived problem of separation of asset origination from ownership, Section 941 of the Dodd-Frank Act attempts to align the interest of securitizers of assets with that of investors in securitization by mandating the Joint Regulators to require securitizers to retain at least a 5% economic interest in the securitization. In theory, because the originator would be exposed to the same economic consequences of the performance of the assets as third party investors, the securitizer would be incentivized to securitize only high quality assets and to originate, or encourage third party originators to originate, only high quality, properly underwritten assets.

Regardless of whether one accepts the premise underlying Section 941 that the best way to align the ineentives of originators and issuers with investors in securitization, and thereby promote higher quality underwriting, is through risk retention, the policy it seeks to support clearly has no applicability to Corporate Debt Repackagings. Unlike traditional asset-backed securities, such as securities backed by residential or commercial mortgage loans, automobile loans or leases, or student loans, Corporate Debt Repackagings are not part of the process of directly or indirectly financing the origination of consumer loans or other financial assets. Instead, they represent the reoffering of existing debt securities of corporate issuers acquired in the secondary market. Those corporate debt securities are not created by the underlying corporations with the intention or expectation that they will be acquired and securitized, and the existence or terms of those corporate debt obligations are not dictated or influenced by the possibility that they be included in Corporate Debt Repackagings. The sponsor of a Corporate Debt Repackaging will not acquire the underlying corporate bonds directly from the issuer thereof nor will the bonds represent an unsold allotment held by the sponsor. Accordingly, the retention of an interest in the corporate bonds underlying a Corporate Debt Repackaging would serve no public interest nor further the protection of investors, as such risk retention would have no effect, directly or indirectly, on the creation of the asset underlying the securitization, the credit quality of which is solely dependent on the credit of the issuer of the underlying corporate bond and not a third party, such as a mortgagor or automobile purchaser, that is the subject of credit underwriting. We find implicit support for that conclusion in the Federal Reserve Study, which suggested tailoring mechanisms to align incentives to different asset classes. While the Federal Reserve Study addressed nine different asset classes, it made no mention of Corporate Debt Repackagings, presumably because the logic behind Section 941 of the Dodd-Frank Act

simply does not apply to that asset class. In that regard, Corporate Debt Repackagings are distinguishable from collateralized debt obligations, the assets of which consist of ABS, primarily RMBS, and which, as discussed above, are perceived to influence the process in which credit is extended to the borrower of the underlying assets.

## III. FDIC's Securitization Safe Harbor as Compelling Evidence of the Need for a Coordinated Approach to Risk Retention

### *i. Summary*

ASF has consistently supported risk retention as a mechanism to better align the economic interests of originators and sponsors with securitization investors, but proposals with risk retention requirements have come in several different forms, including SEC rule proposals under "Regulation AB II" and FDIC rules relating to its securitization safe harbor rule for insured depository institutions.

ASF has forcefully advocated that regulators develop risk retention requirements on a coordinated, interagency basis, in accordance with Congress' mandate under Section 941 of Dodd-Frank, and has cautioned that unilateral rule-making would introduce multiple layers of regulation addressing the same core issues, which would be extremely detrimental to the recovery of the fragile securitization markets.

While the SEC appears to have deferred action on its risk retention rule proposals until the regulatory processes relating to the Dodd-Frank risk retention requirements are completed, the FDIC has brashly moved forward to adopt a securitization safe harbor that effectively preempted Congress' mandate to develop risk retention regulations on an interagency basis.

The FDIC's securitization safe harbor contains several provisions, including rigid and narrowly-drawn risk retention provisions, that operate as levers to regulate the securitization markets rather than as conditions relevant to its powers as conservator or receiver. In particular, the FDIC established:

- a one-size-fits-all risk retention requirements that are neither calibrated to the credit and performance characteristics of a particular asset type nor mindful of the manner in which securitizers have retained exposure to credit risk historically;
- disclosure standards for securitization transactions that are different from the SEC's own disclosure rules; and
- documentation and servicing requirements that overlap with provisions of Dodd-Frank and related implementing regulations.

As a result, banks that seek to sponsor securitization transactions are subject to multiple, overlapping (and, in the case of the FDIC's safe harbor, hastily prepared) requirements, which impede the recovery of the securitization markets by needlessly deterring banks from the use of securitization.

As noted above, ASF believes the language and legislative history of Section 941 indicate that Congress expected risk retention regulations to be developed on a coordinated, interagency basis. Accordingly, ASF requests that Congress pass legislation providing that, except as set forth in Section 15G of the Exchange Act, no governmental agency shall promulgate risk retention regulations, and that any such regulations previously promulgated are repealed by the terms of such legislation and without need of further action by any such agency.

***ii. Discussion***

ASF supports efforts to align the economic interests of originators and sponsors with securitization investors and agrees that risk retention is one mechanism that can help establish a better alignment of interests. New laws, regulations and proposals with risk retention requirements have, however, come in several different forms. At the time, Dodd-Frank was adopted by the United States Congress and signed into law by the President, rule proposals with independent risk retention provisions were put forth for public comment by (i) the FDIC relating to the treatment by the FDIC as conservator or receiver of financial assets transferred by an insured depository institution (a "Bank") in connection with a securitization or participation transaction and (ii) the SEC relating to offering, disclosure and reporting requirements for ABS.[46]

ASF submitted extensive comment letters to each of the FDIC and the SEC noting that their respective risk retention proposals overlapped significantly with the risk retention requirements in Dodd-Frank and that the regulatory processes to implement the Dodd-Frank risk retention requirements were moving forward rapidly. ASF urged the FDIC and the SEC, therefore, to impose risk retention requirements only on a coordinated basis, in accordance with the legislative mandate that such regulations be developed on an interagency basis, as informed by the findings and recommendations presented to Congress in several risk retention reports mandated under Dodd-Frank.

ASF expressed serious concerns that, in the event either the FDIC or the SEC were to impose risk retention requirements before the regulatory processes relating to risk retention were

[46] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010); Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation After September 30, 2010 (75 FR 27471, May 17, 2010); Asset-Backed Securities (75 FR 23328, May 3, 2010).

complete, and on a unilateral rather than interagency basis, issuers might ultimately be subject to multiple and possibly conflicting requirements. ASF also cautioned that if reform were to occur at several levels and over time, revitalization of the securitization markets would inevitably be slowed, with many issuers exiting the securitization market with the enactment of the first set of rules and returning, if at all, only after all of the contemplated legislative and regulatory actions had been taken. Moreover, if the aggregate burden for issuers were ultimately too great, ASF cautioned that issuers might significantly reduce or cease their securitization activities and rely on more limited and costly alternative sources of funding, resulting in a corresponding contraction of available credit for consumer finance and small business, including mortgage loans, auto loans and leases, small business loans and credit cards.

Notwithstanding the concerns expressed by ASF and by other market participants, and even by other governmental agencies, on September 27, 2010, the FDIC effectively preempted Congress' mandate to develop risk retention regulations on an interagency basis by including in its final securitization safe harbor a requirement that the sponsor must retain at least five percent of the credit risk of the financial assets in one of two ways – (i) through retention of a "vertical slice" of at least five percent of each tranche transferred to investors or (ii) by retaining in its portfolio a "representative sample" in an amount equal to at least five percent of the securitized assets.[47] The FDIC's final safe harbor does contain an "auto-conform" provision that will replace the credit risk retention requirements described above with those implemented under Dodd-Frank when they become effective. As discussed below, however, the FDIC's risk retention requirements that are now in place are too rigid and narrowly drawn and the Dodd-

[47] In contrast, the SEC appears to have deferred action on its risk retention rule proposals until the regulatory processes relating to the Dodd-Frank risk retention requirements are completed.

Frank risk retention regulations have only recently been proposed, and so their effective date is still over a year from now in the case of RMBS and over two years from now in the case of all other classes of ABS. In addition, as discussed further below, Banks that sponsor revolving asset master trust securitization transactions could face more unique transition issues under the FDIC's auto-conform provision.

Last month, in accordance with Section 941 of Dodd-Frank, the Joint Regulators charged with the responsibility to prescribe risk retention regulations issued the Proposed Regulations for that purpose.[48] Both the language and legislative history of Section 941 indicate that Congress expected the Joint Regulators, in formulating these rules, to be mindful of the heterogeneity of securitization markets and to give due consideration to the findings and recommendations presented to Congress in certain risk retention studies and reports mandated by Section 941.[49] Consistent with this Congressional mandate, the Joint Regulators indicate that they have taken into account the diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which securitizers may have retained exposure to the credit risk of the assets they securitize. As a result, unlike the FDIC's final securitization safe harbor, the Proposed Regulations under Dodd-Frank provide a range of options that securitizers may

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[48] Section 15G to the Securities Exchange Act of 1934, as added by Section 941 of Dodd-Frank, generally requires the FRB (the "Board"), the Office of the Comptroller of the Currency, the FDIC, the SEC, the Federal Housing Finance Agency and the Department of Housing and Urban Development to jointly prescribe risk retention regulations that (i) require a securitizer to retain not less than five percent of the credit risk of any asset that the securitizer, through the issuance of ABS, transfers, sells, or conveys to a third party, and (ii) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under Section 15G.

[49] *See, e.g.*, 15 U.S.C. § 78o-11(c)(1)(E), (c)(2), (e); S. Rep. no. 111-76, at 130 (2010) ("The Committee believes that implementation of risk retention obligations should recognize the differences in securitization practices for various asset classes."). Section 941 of Dodd-Frank directed each of the Board and the Financial Services Oversight Counsel to study certain effects of the risk retention requirements and promptly report their findings to Congress. *See generally* Report to the Congress on Risk Retention, Board of Governors of the Federal Reserve System (October 2010); *see also* Macroeconomic Effects of Risk Retention Requirements, Chairman of the Financial Stability Oversight Counsel (January 2011).

choose from in meeting the risk retention requirements, including: (i) retention of a "vertical slice" of each class of interest issued in the securitization, (ii) retention of an "eligible horizontal residual interest" in the securitization, (iii) use of "L-Shaped" risk retention, which combines both vertical and horizontal forms, (iv) in the case of revolving asset master trusts, retention of a "seller's interest" that is generally *pari passu* with the investors' interest in the revolving assets supporting the ABS, (v) retention in its portfolio of a "representative sample" of assets equivalent to the securitized assets; and (vi) other risk retention options that purport to take into account the manner in which risk retention often has occurred in connection with the issuance of ABCP and in commercial mortgage-backed securitization transactions.[50]

Moreover, as directed by Congress, the Joint Regulators' Proposed Regulations purport to calibrate risk retention with asset quality by exempting ABS supported by qualified residential mortgages and ABS supported by other high quality assets from any risk retention requirement.

By contrast, the risk retention requirements in the FDIC's final securitization safe harbor embrace a blanket one-size-fits-all retention requirement that is arbitrary in its application to any particular asset type because it does not account for important differences in the expected credit and performance characteristics of one asset type as compared with another asset type. Nor does it account for the diversity of assets that are securitized, the structures historically used in securitizations, or the manner in which securitizers may have retained exposure to the credit risk of the assets they securitize. Many sponsors already have significant equity and other investments in the capital structure of their securitization transactions in the form of seller's

[50] Notably, as to each proposed form of eligible risk retention, the Joint Regulators have also set forth a host of questions for which public comment is sought – questions that evidence both the complexity of the rule-making initiative and the care that is required to produce regulations that appropriately balance the competing objectives of aligning economic interests while preserving securitization as a viable and economical alternative relative to other funding options.

interests, subordinated and first-loss positions, excess spread that represents an interest in excess finance charge collections, over-collateralization, reserve accounts and the like. Adding a vertical slice component as contemplated by the FDIC's safe harbor will almost certainly add too much incremental cost and render securitization transactions uneconomical relative to other funding options available to the sponsor.

As an alternative to a vertical slice, the FDIC's safe harbor does contemplate retention of a representative sample as a means of risk retention, but the FDIC's version of this option is formulated differently than the representative sample option included in the Joint Regulators' Proposed Regulations, and so a Bank seeking to avail itself of this option would have to adopt one set of procedures to comply with the FDIC safe harbor in its current form and then a different set of procedures at such time as the auto-conform provision takes effect. It also remains to be seen whether representative sampling is even a meaningful option for some asset classes, such as established revolving asset master trusts with existing securitized portfolios.

Banks that sponsor revolving asset master trust securitization transactions could face more unique transition issues under the FDIC's auto-conform provision. Master trusts allow sponsors to employ a single issuing vehicle to issue multiple issuances of ABS over time. Each issuance provides for the conveyance of additional pool assets in contemplation of future issuances of ABS backed by the same revolving asset pool. Master trusts represent a more integrated form of structuring technology, where each issuance forms a part of the more complete structure of the issuance platform. It is of paramount importance, therefore, that the sponsor of a master trust securitization platform have the option (but not the requirement) to select and maintain the same form of risk retention over the life of the master trust. If a Bank were to sponsor a revolving asset master trust securitization transaction in conformity with the

more limited risk retention options currently available under the FDIC safe harbor, the sponsor could effectively be relegated to that form of risk retention for all of the master trust's future ABS issuances, even if a broader (and potentially more efficient) range of options becomes available at such time as the auto-conform provision of the FDIC safe harbor takes effect.[51]

We recognize that legislators and regulators have an interest in fashioning effective regulations to enhance practices of issuers and confidence of investors, but it is critical that legislators and regulators work in concert with, and not in opposition to, one another. Simply stated, by imposing rigid and narrowly-drawn risk retention requirements on Banks that sponsor securitization transactions before the regulatory processes relating to risk retention have been completed, the FDIC has impeded the recovery of the securitization markets by needlessly deterring Banks from the use of securitization.

Accordingly, ASF requests that Congress pass legislation providing that, except as set forth in Section 15G of the Exchange Act, no governmental agency shall promulgate risk retention regulations, and that any such regulations previously promulgated are repealed by the terms of such legislation and without need of further action by any such agency.

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[51] The FDIC's prior securitization safe harbor, adopted a rule in 2000, provided that the FDIC, as conservator or receiver of a Bank, would not use its statutory authority to disaffirm or repudiate contracts in order to reclaim financial assets transferred by a Bank in connection with a securitization or participation if the transfer met all conditions for sale accounting treatment under GAAP. On June 12, 2009, the Financial Accounting Standards Board ("FASB") modified GAAP through FAS 166 and FAS 167, which represent accounting standards that make it more difficult for a transferor of assets in a securitization to meet the conditions for sale accounting treatment. These modifications became effective for annual financial statement reporting periods that began after November 15, 2009.
The FDIC's new securitization safe harbor contains a grandfathering provision that makes the safe harbor available for securitization transactions by revolving or master trusts *at any time*, as long as the trust had issued ABS prior to September 27, 2010 and transfers of pool assets in connection with issuances of ABS backed by the same, revolving pool satisfy the GAAP conditions for sale accounting treatment as in effect prior to November 15, 2009.
This grandfathering provision is *not*, however, available for revolving or master trusts that initially issue ABS only on or after September 27, 2010 or that transfer pool assets in connection with issuances of ABS backed by the same, revolving pool in a manner that does not satisfy those prior GAAP conditions for sale accounting treatment.

As a final observation, the FDIC's securitization safe harbor contains several other provisions that, like its risk retention provisions, operate more as levers to regulate the securitization markets than as conditions to its powers as conservator or receiver and, once again, effectively preempt the efforts of Congress and other agencies to do so. For example, the FDIC's safe harbor establishes disclosure standards for securitization transactions that are different from the SEC's disclosure rules, subjecting issuers to multiple and potentially conflicting requirements. Similarly, the safe harbor imposes specific documentation and servicing requirements on all types of transactions and imposes additional requirements in these areas for securitizations of residential mortgage loans, while some of these subjects are also covered by the Joint Regulators' risk retention rule proposals and are expected to be covered by proposals for uniform national servicing standards later this year. ASF remains deeply concerned that the fragile securitization markets are continuing to face unnecessary uncertainty and the potential for costly administrative changes as a result of multiple layers of regulation addressing the same basic issues and introduced on a staggered basis.

## IV. Hedging, Transfer and Financing Restrictions

Our membership is generally supportive of the hedging, transfer and financing restrictions set forth in the Proposed Regulations. However, we believe that it is appropriate for a sponsor to be permitted to hedge, transfer or finance its retained interest free of these restrictions after a specified number of years has elapsed from the issuance of the ABS. By requiring a sponsor to retain a portion of the credit risk in the underlying assets for a specified number of years, the Congressional goal of promoting sound underwriting practices will clearly be met without permanently limiting the liquidity of the retained interest. Sponsors will be

motivated to originate assets with good credit characteristics knowing that they will retain a portion of the risk of default on those assets for a substantial period of time. This is especially true since historically the assets underlying ABS transactions are more likely to default early in their terms, and become less likely to default as they become more seasoned.

In addition, we are concerned that it may be difficult for large institutions to effectively monitor compliance with the hedging restrictions across all divisions, departments and affiliates. The division, department or entity responsible for the securitization transaction may have entirely different personnel and be far removed, both in terms of internal corporate structure and geography, from the divisions, departments or affiliated entities that engage in hedging transactions. Therefore, the possibility exists for the sponsor or an affiliate to inadvertently violate the hedging restrictions. In order to prevent such unintentional violations from triggering a breach of the risk retention rules, we propose that the Joint Regulators establish a safe harbor pursuant to which a sponsor that establishes reasonable procedures to protect against inadvertent hedging of retained interests would not be deemed to have violated the hedging restrictions in the event such inadvertent hedging occurs. The establishment of such safe harbor would be entirely consistent with the goals of the risk retention rules, since sponsors would need to make decisions regarding the credit quality of the assets being securitized with the assumption that the sponsor would be retaining a portion of the risk associated with such assets. The potential for inadvertent hedging would in no way alter that analysis.

Finally, we note that within the section that describes permitted hedging activities, including hedging of interest rate risk, the exclusion of "spread risk, associated with the ABS interest that is otherwise considered part of the credit risk" is confusing and unnecessary. Changes in the spread against an interest rate benchmark, as used in valuing any given asset-

backed security, may occur due to a number of factors other than ones that relate to the perceived credit risk of the security, most notably overall market conditions as they affect liquidity. In a liquidity crunch, spreads may widen due simply to the lack of bidders, as opposed to any change in the credit risk of a security. A spread hedge that is not linked to the spread on the specific security would not necessarily hedge credit risk. For example, if the sponsor is required to retain as part of a vertical slice 5% of the "AAA" rated class in a given securitization backed by 30-year prime, fixed rate loans, a hedge against changes in market spreads over a benchmark for generic 30-year fixed rate loan "AAA" rated RMBS (or an index thereof) would not act as a hedge against credit risk on the class required to be retained.

## V. Concerns Relating to the Issuance of Interpretive Guidance

The Proposed Regulations contemplate that any written interpretive guidance relating to the risk retention regulations that is intended to be relied upon by the public generally will be issued jointly by the appropriate agencies. We do not believe this approach is appropriate. The process of obtaining guidance from a single regulator is often onerous and time consuming. Attempting to obtain advice from multiple regulators, each with their own perspectives on how the rules should be interpreted, will likely prove unworkable. In addition, cases are likely to arise where different agencies simply have different good faith interpretations of what the regulations mean. We propose instead that a single agency be appointed to be responsible for issuing interpretative guidance with respect to each discrete aspect of the regulations. This approach seems particularly sensible in light of the fact that the Joint Regulators generally have differing areas of expertise and focus, and therefore certain agencies are better equipped to

interpret some parts of the regulations, while other agencies are better equipped to interpret other parts of the regulations

## VI. Conclusion

In conclusion, ASF supports efforts to align the incentives of issuers and originators with securitization investors and believe these incentives should encourage the application of sound underwriting standards by both the originator and securitizer in connection with the assets that are securitized. We believe that risk retention can aid in achieving this goal so long as the requirements take the foregoing comments into consideration. ASF will continue to work to provide industry comment on all proposals issued by the various regulatory agencies as well as to promulgate best practices for securitization governance in order to restore confidence in this very important market. The ASF greatly appreciates the invitation to appear before this Subcommittee to share our views related to these current issues. I look forward to answering any questions the Subcommittee may have.

Thank you.

**APPENDIX A**

**Role of Securitization within the Financial System and U.S. Economy**

**The Current State of the Market**

As the Board noted in its recent study on risk retention, different segments of the ABS and MBS markets have recovered differently during the 18 months since the recession ended.[52] Auto and auto-related ABS accounted for $53.9 billion in issuance in 2009, which represents 80.7% of the auto and auto-related ABS issuance of $66.8 billion during 2007, just before the downturn.[53] $7.2 billion in equipment ABS was issued during 2009, in contrast with the 2007 issuance of $6.1 billion.[54] In 2009, credit card ABS accounted for $46.6 billion in issuance, down 50.7% from 2007 issuance of $94.5 billion.[55] Meanwhile, the student loan sector issued $20.8 billion in ABS during 2009, down 64.2% from 2007 issuance of $58.1 billion.[56] By comparison, on the RMBS side, $48.1 billion of RMBS were issued in 2009, down 92.5% from 2007 issuance of $641.8 billion.[57] In addition to the overall reduction of issuance in the RMBS market, we further note that 97% of RMBS were issued by the Agencies in 2010, as compared with only 64% in 2007 when the private market accounted for a much larger share of RMBS issuance.[58]

Simply put, the absence of a properly functioning securitization market, and the funding and liquidity this market has historically provided, adversely impacts consumers, businesses, financial markets and the broader economy. The recovery and restoration of confidence in

[52] Board of Governors of the Federal Reserve System, "Report to the Congress on Risk Retention" (Oct. 2010), pg. 2. < http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf>.
[53] Data are from Asset Backed Alert, see the Proposing Release, pg. 12-13.
<http://www.sec.gov/rules/proposed/2011/34-64148.pdf>.
[54] Ibid.
[55] Ibid.
[56] Ibid.
[57] Ibid.
[58] Analysis by 1010data, based on data from FNMA, GNMA and FHLMC.

securitization is therefore a necessary ingredient for economic growth to resume, and for that growth to continue on a sustained basis into the future. ASF supports efforts to align the incentives of issuers and originators with securitization investors and believe these incentives should encourage the application of sound underwriting standards by both the originator and securitizer in connection with the assets that are securitized. We believe that risk retention can aid in achieving this goal so long as the requirements are tailored to each class of securitized assets as described in this testimony. We believe that the Joint Regulators must carefully calibrate the risk retention requirements so as to not impede the securitization markets recovery and further constrain the availability of credit.

**Why is Securitization Important?**

Securitization—generally speaking, the process of pooling and financing consumer and business assets in the capital markets by issuing securities, the payment on which depends primarily on the performance of those underlying assets—plays an essential role in the financial system and the broader U.S. economy. Over the past 40 years, securitization has grown from a relatively small and unknown segment of the financial markets to a mainstream source of credit and financing for individuals and businesses alike.

In recent years, the role that securitization has assumed in providing both consumers and businesses with credit is striking: currently, there is over $11 trillion of outstanding securitized assets, including RMBS, ABS and ABCP. This represents a market substantially larger than the normal size of all outstanding marketable U.S. Treasury securities—bonds, bills, notes, and TIPS combined.[59] Between 1990 and 2006, issuance of MBS grew at an annually compounded rate of

[59] U.S. Department of the Treasury, "Monthly Statement of the Public Debt of the United States: January 31, 2011," (January 2011). <http://www.treasurydirect.gov/govt/reports/pd/mspd/2011/opds012011.pdf>.

13%, from $259 billion to $2 trillion a year.[60] In the same time period, issuance of ABS secured by auto loans, credit cards, home equity loans, equipment loans, student loans and other assets, grew from $43 billion to $753 billion. In 2006, just before the downturn, nearly $2.9 trillion in RMBS and ABS were issued. As these data demonstrate, securitization is clearly an important sector of today's financial markets.

The importance of securitization becomes more evident by observing the significant proportion of consumer credit it has financed in the U.S. It is estimated that securitization has funded between 30% and 75% of lending in various markets, including an estimated 64% of outstanding home mortgages.[61] Securitization plays a critical role in non-mortgage consumer credit as well. Historically, banks securitized 50-60% of their credit card assets.[62] Meanwhile, in the auto industry, approximately 91% of auto industry sales are financed through auto ABS.[63] Overall, recent data collected by the Board show that securitization has provided over 25% of outstanding U.S. consumer credit.[64] Securitization also provides an important source of commercial mortgage loan financing throughout the U.S., through the issuance of CMBS.

Over the years, securitization has grown in large measure because of the benefits and value it delivers to transaction participants and to the financial system. Among these benefits and value are the following:

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[60] National Economic Research Associates, Inc. ("NERA"), "Study of the Impact of Securitization on Consumers, Investors, Financial Institutions and the Capital Markets," pg. 16 (June 2009).
<http://www.americansecuritization.com/uploadedFiles/ASF_NERA_Report.pdf> (the "NERA Study")
[61] Fitch Ratings, "U.S. Housing Reform Proposal FAQs: Filling the Void" pg. 1-2 (Feb. 2011).
<http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=606315> (free registration required).
[62] Citigroup, "Does the World Need Securitization?" pg. 10 (Dec. 2008).
<http://www.americansecuritization.com/uploadedFiles/Citi121208_restart_securitization.pdf>.
[63] Ibid., pg. 10.
[64] Federal Reserve Board of Governors, "G19: Consumer Credit," (Sept. 2009).
<http://www.federalreserve.gov/releases/g19/current/g19.htm>.

A. *Efficiency and Cost of Financing.* By linking financing terms to the performance of a discrete asset or pool of assets, rather than to the future profitability or claims-paying potential of an operating company, securitization often provides a cheaper and more efficient form of financing than other types of equity or debt financing.

B. *Incremental Credit Creation.* By enabling capital to be raised via securitization, lenders can obtain additional funding from the capital markets that can be used to support incremental credit creation. In contrast, loans that are made and held in a financial institution's portfolio occupy that capital until the loans are repaid.

C. *Credit Cost Reduction.* The economic efficiencies and increased liquidity available from securitization can serve to lower the cost of credit to consumers and businesses. Several academic studies have demonstrated this result. A recent study by National Economic Research Associates, Inc., concluded that securitization lowers the cost of consumer credit, reducing yield spreads across a range of products including residential mortgages, credit card receivables and automobile loans.[65]

D. *Liquidity Creation.* Securitization often offers issuers an alternative and cheaper form of financing than is available from traditional bank lending, or debt or equity financing. As a result, securitization serves as an alternative and complementary form of liquidity creation within the capital markets and primary lending markets.

E. *Risk Transfer.* Securitization allows entities that originate credit risk to transfer that risk throughout the financial markets to parties willing to assume it, such as institutional investors and hedge funds.[66]

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[65] NERA Study, pg. 16. <http://www.americansecuritization.com/uploadedFiles/ASF_NERA_Report.pdf>.

[66] The vast majority of investors in the securitization market are institutional investors, including banks, insurance companies, mutual funds, money market funds, pension funds, hedge funds and other large pools of capital.

*F. Customized Financing and Investment Products.* Securitization allows for precise and customized creation of financing and investment products tailored to the specific needs of both issuers and investors. For example, issuers can tailor securitization structures to meet their capital needs and preferences and diversify their sources of financing and liquidity. Investors can tailor securitized products to meet their specific credit, duration, diversification and other investment objectives.

Recognizing these and other benefits, policymakers globally have taken steps to help encourage and facilitate the recovery of securitization activity. Discussing the Joint Regulators' risk retention rulemaking, Acting Comptroller of the Currency John Walsh stated, "I think it's vital that we craft a final rule that does not impede the revival of the securitization markets. We will be hard pressed to fund the needs of American consumers, particularly in the area of housing, without securitization..."[67] The G-7 finance ministers, representing the world's largest economies, declared that "the current situation calls for urgent and exceptional action...to restart the secondary markets for mortgages and other securitized assets."[68] The Department of the Treasury stated in March, 2009, that "while the intricacies of secondary markets and securitization...may be complex, these loans account for almost half of the credit going to Main Street,"[69] underscoring the critical nature of securitization in today's economy. The Chairman of the Board noted that securitization "provides originators much wider sources of funding than they could obtain through conventional sources, such as retail deposits" and also that "it

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[67] Walsh, John, "Remarks Before the American Bankers Association Government Relations Summit." *Office of the Comptroller of the Currency* (March 2011). <http://www.occ.treas.gov/news-issuances/speeches/2011/pub-speech-2011-26.pdf>.
[68] G-7 Finance Ministers and Central Bank Governors Plan of Action (Oct. 10, 2008). <http://www.treas.gov/press/releases/hp1195.htm>.
[69] U.S. Department of the Treasury, "Road to Stability: Consumer & Business Lending Initiative," (March 2009). <http://www.financialstability.gov/roadtostability/lendinginitiative.html>.

substantially reduces the originator's exposure to interest rate, credit, prepayment, and other risks."[70] Echoing that statement, the Financial Stability Oversight Council in its recent study on *Macroeconomic Effects of Risk Retention Requirements* stated that, "By providing access to the capital markets, securitization has improved the availability and affordability of credit to a diverse group of businesses, consumers, and homeowners in the United States." There is clear recognition in the official sector of the importance of the securitization process and the access to financing that it provides lenders as well as its importance in providing credit that ultimately flows to consumers, businesses and the real economy.

Restoration of function and confidence to the securitization markets is a particularly urgent need, in light of capital and liquidity constraints currently confronting financial institutions and markets globally. As mentioned above, at present nearly $11 trillion in U.S. assets are funded via securitization. With the process of bank de-leveraging and balance sheet reduction still underway, and with increased bank capital requirements on the horizon, such as those expected in Basel III, the funding capacity provided by securitization cannot be replaced with deposit-based financing alone in the current or foreseeable economic environment. In fact, the IMF estimated that a financing "gap" of $440 billion existed between total U.S. credit capacity available for the nonfinancial sector and U.S. total credit demand from that sector for the year 2009.[71] Moreover, non-bank finance companies, which have played an important role in providing financing to consumers and small businesses, are particularly reliant on securitization to fund their lending activities, because they do not have access to deposit-based

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[70] Bernanke, Ben S., "Speech at the UC Berkeley/UCLA Symposium: The Mortgage Meltdown, the Economy, and Public Policy, Berkeley, California." *Board of Governors of the Federal Reserve System* (Oct. 2008). <http://www.federalreserve.gov/newsevents/speech/bernanke20081031a.htm>.

[71] International Monetary Fund, "The Road to Recovery." *Global Financial Stability Report: Navigating the Financial Challenges Ahead* (Oct. 2009), pg. 29. <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf>.

funding. Small businesses, which employ approximately 50% of the nation's workforce, depend on securitization to supply credit that is used to pay employees, finance inventory and investment, and fulfill other business purposes. Furthermore, many jobs are made possible by securitization. For example, a lack of financing for mortgages hampers the housing industry; likewise, constriction of trade receivable financing can adversely affect employment opportunities in the manufacturing sector. To jump start the engine of growth and jobs, securitization is needed to help restore credit availability.

**Testimony of Ellen Harnick**
**Center for Responsible Lending**

**Before the U.S. House of Representatives**
**Subcommittee on Capital Markets and**
**Government Sponsored Enterprises**

**"Understanding the Implications and Consequences of the Proposed Rule on Risk Retention"**

***April 14, 2011***

Good afternoon Chairman Garrett, Ranking Member Waters, and members of the subcommittee. Thank you for the invitation to discuss the very important issue of reforming the performance of the secondary market for residential mortgages, where reckless practices fueled reckless lending and a foreclosure crisis that has impoverished families, destroyed neighborhoods, and triggered a global financial crisis.

I serve as Senior Policy Counsel at the Center for Responsible Lending (CRL), a nonprofit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth. CRL is an affiliate of the Center for Community Self-Help ("Self-Help"), a nonprofit community development financial institution. For thirty years, Self-Help has focused on creating asset building opportunities for low-income and minority families, primarily through financing safe, affordable home loans that have enabled thousands of families to build assets for the first time. In total, Self-Help has provided over $5.6 billion of financing to 64,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across America.

## I. Introduction and Summary

You have asked us today to consider the implications and consequences of the proposed rule on risk retention for securitized assets. We are most concerned about the impact of the proposed rule on the market for residential mortgages. In our view, the proposed rule would squander an opportunity to ensure that well-structured, responsibly underwritten and appropriately serviced mortgage loans become widely available to all credit-worthy families. If the private label securities market makes a substantial comeback, it would relegate many creditworthy families to second-tier, less sustainable mortgage loans. Access to responsibly structured, properly serviced loans is particularly important for families who lack the wealth to sustain payment shock or hedge against interest rate risk.

For this reason, we agree with the agencies that the "Qualified Residential Mortgage" (QRM) exception to the risk retention rules should apply only to loans whose terms are responsible and sustainable, and that are underwritten to ensure the borrower's ability to repay based on documented income. Where we differ with the agencies is in our strong

belief that such loans should be broadly available to credit-worthy families. Ideally, these should be the loans of choice for most borrowers. Loans that do not meet these standards should remain available, but should be the exception, not the dominant product, and should be subject to strict regulatory oversight to address abuses. We believe that was the intent of Congress.

The proposed rule would do exactly the opposite of what we here suggest. It would create a category of responsible mortgages, but make them available to only a small proportion of creditworthy families. This is the result of down-payment, debt to income and credit history requirements so extreme they would exclude much of the middle class, along with large numbers of credit worthy families of color and low- and moderate-income borrowers, from access to QRMs

Respectfully, we believe that the proposed approach is both a bad idea and a missed opportunity and should be revised.

It is a bad idea for two reasons. First, a 5 percent risk-retention requirement for loans outside the QRM definition will come at a cost that will be passed onto borrowers; most borrowers should be able to avoid this added cost – and receive the benefits of a soundly underwritten and fair mortgage – by opting into a QRM. The added cost of non-QRM loans should be the exception rather than the norm. Second, we are concerned that non-QRM loans will be stigmatized by lenders, considered unsafe by bank examiners, and will be made more costly or less available as a result. The rule should be reworked to ensure that most borrowers are able to get a sustainable loan through the QRM.

It is a missed opportunity because the regulators now have the opportunity to drive the market into one dominated by sound, sustainable loans.

Our concerns and suggestions are detailed below.

Almost four years ago, our organization released a report warning that the reckless and abusive lending practices of the previous two decades would lead to approximately 2 million subprime foreclosures. At the time, our report was denounced by the mortgage industry as absurdly pessimistic. Sadly, our projections turned out to be extremely conservative. The damage has been far worse, spreading from the subprime to the prime sectors, catalyzing a housing-lead recession, and triggering historic levels of unemployment.

Since we issued that 2006 report, there have already been as many as 3 million homes lost, and Wall Street analysts recently predicted there could be as many as 11 million more foreclosures filed.[1] The foreclosure crisis has had catastrophic consequences for families and communities. The first wave of homeowners ended up in dire straits owing to abusive mortgage originations, incompetent and predatory mortgage practices, ineffective government oversight, and a complex securitization system that lacks accountability.

Now, millions more are in danger because of the toxic combination of underwater loans and unemployment that festers in so many areas. Even families that never missed a mortgage payment prior to this recession now struggle under financial strains not of their making.

The mortgage lending marketplace has become so problematic that today, private lending is almost non-existent. Government lending is practically the whole market, a circumstance that is not viable over the long term. In order to create a strong housing market moving forward, the private market must come back without repeating the mistakes of the 1990s and early 2000s. The best way to do this is through clear "rules of the road" set forth in the QRM definition that encapsulate the terms of sustainable mortgage lending for most borrowers. Unfortunately instead, the proposal suggests a narrow "gold standard" that will reach a small portion of mortgage borrowers and sets the stage for a two-tiered market to evolve as the private market returns—with good loans for the top tier and substandard loans for the bottom tier.

Some argue that low- and moderate-income borrowers should either take their chanees on non-QRM loans, or be denied eredit altogether. However, denying such families access to the American dream of homeownership – and the ability to build wealth in the long-term – makes no sense. It would be unfair to deny borrowers who can demonstrate an ability to repay a mortgage the ability to build wealth and ties to the community simply because, e.g., they could not afford to put 20 percent down in cash. This would also have negative repercussions for the economy and the ability for middle class families needing to sell their houses, as a healthy market needs a continuous influx of new customers. The failure to consider the needs of first-time homebuyers and customers from low-wealth backgrounds when we create any new system would be catastrophic for future growth.

**Recommendations:**

- QRMs should be responsibly underwritten to ensure the borrower has the capacity to repay the loan by its terms out of documented income, taking account of the borrower's other debt.

- QRM loans should be widely available to qualified borrowers to avoid creating an opportunity for less responsible lending to proliferate. Accordingly, QRM loans should be available to all qualified borrowers without restriction based on whether or not the family has the wealth necessary for a large downpayment. Nor should families be excluded based on rigid credit history or debt-to-income ratios that could strand families in rental housing that costs as much, on a monthly basis, as the monthly cost of homeownership.

- The Risk Retention Rule should, among other things, define QRMs as loans that are sensibly structured in accordance with the requirements of a Qualified Mortgage ("QM") as set out in Title XIV of Dodd-Frank, and to be defined by

the Federal Reserve Board (or later the CFPB). The definition should exclude loan features associated with payment shock or other elevated default risks, including negative amortization, deferred repayment of principal, balloon payments, substantial rate increases, and prepayment penalties

- This definition should also include appropriate loan servicing standards, including the requirement that servicers mitigate losses by taking appropriate action to maximize the net present value of the mortgages for the benefit of all investors (rather than any particular investor class). Servicers should also be required to pursue loss mitigation rather where doing so would yield a net present value that is equal or greater than that from foreclosure. Additionally, the structure of servicer compensation must not operate to encourage foreclosure over loss mitigation. Servicers must also be required to implement a reasonable process for addressing subordinate liens owned by the servicer or any of its affiliates. The interests of the first lien-holders on the property should have priority in the resolution of a troubled loan, and servicers holding second liens should have an absolute fiduciary responsibility to act in the best interests of the first lien-holders, regardless of the servicer's other interests in the property. Finally, servicers should be required to publicly disclose their ownership interests (or those of any affiliate) in any other loans secured by the property that secures any loan in the pool.

## II. Background: The Impact of the Foreclosure Crisis

### A. The foreclosure crisis has affected (and will continue to affect) millions of people.

With one in seven borrowers delinquent on their mortgage or already in foreclosure[2] and more than one in four mortgages underwater,[3] continued weakness in the housing sector is already impairing economic recovery and hampering efforts to create jobs and reduce unemployment. According to industry analysts, the total number of foreclosures by the time this crisis abates could be anywhere between 8 and 13 million.[4] A recent study by CRL estimated that 2.5 million foreclosure sales were completed between 2007 and 2009 alone, while another 5.7 million borrowers are at imminent risk of foreclosure[5]

Beyond the impact of the foreclosures on the families losing their homes, foreclosure "spillover" costs to neighbors and communities are massive. Tens of millions of households where the owners have paid their mortgages on time every month are suffering a decrease in their property values that amounts to hundreds of billions of dollars in lost wealth just because they are located near a property in foreclosure. Depending upon the geography and time period, the estimated impact of each foreclosure ranges from 0.6 percent to 1.6 percent in lost value to nearby homes. CRL estimates that the foreclosures projected to occur between 2009 and 2012 will result in $1.86 trillion in lost wealth, which represents an average loss of over $20,000 for each of the 91.5 million

houses affected.[6] These losses are on top of the overall loss in property value due to overall housing price declines.[7]

In addition, foreclosures cost states and localities enormous sums of money in lost tax revenue and increased costs for fire, police, and other services because vacant homes attract crime, arson, and squatters. As property values decline further, more foreclosures occur, which drive property values down still more. The Urban Institute estimates that a single foreclosure results in an average of $19,229 in direct costs to the local government.[8]

The crisis also has a severe impact on tenants in rental housing. According to the National Low-Income Housing Coalition, a fifth of single-family (one-four unit) properties in foreclosure were rental properties, and as many as 40 percent of families affected by foreclosure are tenants.[9] While tenants now have some legal protection against immediate eviction,[10] most of them will ultimately be forced to leave their homes.[11] Furthermore, a great deal of housing stock is now owned by the banks rather than by new owners. Banks are not in the business of renting homes and are not well suited to carry out the duties required of a landlord.

Compounding the problem of renters losing homes to foreclosure is the impact that the crisis has on other sources of affordable housing. A policy brief from the Joint Center for Housing Studies reports that dramatic changes at Freddie Mac and Fannie Mae and coincident changes in credit markets have disrupted and increased the cost of funding for the continued development of multi-family (five or more units) properties, despite the fact that underwriting and performance has fared better in this segment than in single-family housing.[12] As a result, even though a general over-supply of single-family housing persists, the deficit in the long-term supply of affordable rental housing may still increase.[13]

### B. Badly structured loan products lie at the heart of the mortgage meltdown.

In response to the foreclosure crisis, many in the mortgage industry have evaded responsibility and fended off government efforts to intervene by blaming homeowners for mortgage failures, saying that lower-income borrowers were not ready for homeownership or that government homeownership policies dictated the writing of risky loans.[14] The data refute this claim. Empirical research shows that the elevated risk of foreclosure was an inherent in the structure of the subprime and "exotic" loan products that produced this crisis, and that these same borrowers could easily have qualified for, and sustained, far less risky mortgages that complied with all relevant government policies and regulations.

A number of studies demonstrate that loan performance and loan structure are strongly related. For example, Vertical Capital Solutions found that the least risky loans[15] significantly outperformed riskier mortgages during every year that was studied (2002-

2008), regardless of the prevailing economic conditions and in every one of the top 25 metropolitan statistical areas, holding borrower characteristics constant.[16] That study also confirmed that loan originators frequently steered customers to loans with higher interest rates than the rates for which they qualified and loans loaded with risky features such as exploding interest rates and high prepayment penalties. In fact, 30 percent of the borrowers in the sample (which included all types of loans and borrowers) could have qualified for a safer loan. The Wall Street Journal commissioned a similar study that found 61 percent of subprime loans originated in 2006 "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms."[17]

Even applicants who did not qualify for prime loans could have received sustainable, thirty-year, fixed-rate subprime loans for—at most—half to eight tenths of a percent above the initial rate on the risky ARM loans they were given.[18] Lenders pushed the riskier loans because they produced higher immediate fees and bonuses for them- not due to any government mandate.

CRL's research has demonstrated that common subprime loans with terms such as adjustable rates with steep built-in payment increases and lengthy and expensive prepayment penalties presented an elevated risk of foreclosure *even after accounting for differences in borrowers' credit scores.*[19] A 2008 study from the University of North Carolina at Chapel Hill supports the conclusion that risk was inherent in the structure of the loans themselves.[20] In this study, the authors found a cumulative default rate for recent borrowers with subprime loans to be more than three times that of comparable borrowers with lower-rate loans. Furthermore, the authors found that adjustable interest rates, prepayment penalties, and mortgages sold by brokers were all associated with higher loan defaults. In fact, when risky features were layered into the same loan, the resulting risk of default for a subprime borrower was four to five times higher than for a comparable borrower with the lower- and fixed-rate mortgage from a retail lender.

Finally, CRL conducted a more targeted study to focus on the cost differences between loans originated by independent mortgage brokers and those originated by retail lenders. In that study, we found that for subprime borrowers, broker-originated loans were consistently far more expensive than retail-originated loans, with additional interest payments ranging from $17,000 to $43,000 per $100,000 borrowed over the scheduled life of the loan.[21] Even in the first four years of a mortgage, a typical subprime borrower who used a broker paid $5,222 more than a borrower with similar creditworthiness who received a loan directly from a lender.[22] The data overwhelmingly supports that irresponsible lending and toxic loan products lie at the heart of the crisis.

### C. Minority families and communities of color bear a disproportionate burden of the foreclosure crisis.

It is well documented that African-American and Latino families disproportionately received the most expensive and dangerous types of loans during the heyday of the subprime market.[23] CRL research demonstrates that, not surprisingly, communities of color are now disproportionately experiencing foreclosure.

In June 2010, our report, "Foreclosures by Race and Ethnicity: The Demographics of a Crisis" found that African-Americans and Latinos have experienced completed foreclosures at much higher rates than whites, even after controlling for ineome.[24] While the majority of foreclosed families -an estimated 56 percent-involved a white family, when looking at rates within racial and ethnic groups, nearly 8 percent of both African-Americans and Latinos had already lost a home, compared with 4.5 percent of whites. We conservatively estimate that, among homeowners in 2006, 17 percent of Latino and 11 percent of African-American homeowners have lost or are at imminent risk of losing their home, compared with 7 percent of non-Hispanic white homeowners. The losses extend beyond families who lose their home: From 2009 to 2012, those living near a foreclosed property in African American and Latino communities will have seen their home values drop more than $350 billion.

Another CRL report issued in August 2010, "Dreams Deferred: Impacts and Characteristics of the California Foreclosure Crisis," shows that more than half of all foreclosures in that state involved Latinos and African Americans.[25] Contrary to the popular narrative, most homes lost were not sprawling "McMansions," but rather were modest properties that typically were valued significantly below area median values when the home loan was made.

The impact of this crisis on families and communities of color is devastating. Homeownership is the primary source of family wealth in this country, and people often tap home equity to start a new business, pay for higher education and secure a comfortable retirement. In addition, home equity provides a financial cushion against unexpected financial hardships, such as job loss, divorce or medical expenses. Perhaps most important, homeownership is the primary means by which wealth is transferred from one generation to the next, which enables the younger generation to advance further than the previous one. Minority families already have much lower levels of wealth than white families, and therefore this crisis not only threatens the financial stability and mobility of individual families but also exacerbates an already enormous wealth gap between whites and communities of color.[26]

### D. Although Fannie Mae and Freddie Mac should not have purchased subprime MBS, their purchases did not cause the crisis.

The roles of Federal National Mortgage Association ("Fannie Mae" or "Fannie") and the Federal Home Loan Mortgage Corporation ("Freddie Mac" or "Freddie") have certainly had an impact on the shape of the housing market and the availability of certain products over the course of their existence. However, Fannie and Freddie did not cause the subprime crisis.

While Fannie Mae and Freddie Mac should not have purchased subprime mortgage-backed securities (and organizations such as ours urged them not to), their role in purchasing and securitizing problem loans was small in comparison with that of private industry. *All subprime mortgage backed securities were created by Wall Street.* Fannie

Mac and Freddie Mac did not themselves securitize any of these loans because the loans did not meet their standards.[27] When they finally began to purchase the MBS, they were relative late-comers to a market that had been created by private sector firms, and they also purchased only the least risky tranches of these securities.[28]

Ironically, as subprime lending rose, the GSEs' role in the overall mortgage market diminished substantially. As of 2001, Fannie Mae and Freddie Mac funded almost two-thirds of home mortgage loans across the United States. These were loans that Fannie Mae and Freddie Mac purchased directly from originators who met the GSE guidelines and the GSEs either held on their balance sheets or securitized and sold to investors. Subprime loans accounted for just 7 percent of the market. Around 2003, private issuers were beginning to introduce new, riskier loan products into the market, and began to displace the GSEs. In early 2004, private-issue MBS surpassed the GSE issuances of all loans, and by early 2006, Fannie and Freddie's market share of new issuances had dropped to one-third of the total. As the role of the GSEs was declining, the percentage of subprime loans in the mortgage market almost tripled.[29]

Eventually, Fannie and Freddie guaranteed and securitized Alt-A loans—loans to relatively wealthier borrowers with higher credit scores and risky features such as limited documentation. These investments are the primary source of the GSEs' losses, and are the reason why the GSEs were placed into conservatorship.[30] But here too, the GSEs did not lead the market; rather, they followed the market into these loans. The market did not depend on the GSEs.

Finally, it is important to note that GSE loans—including loans to "riskier" borrowers—are performing better than the private market. As of June 2010, 13.35 percent of GSE loans to borrowers with credit scores under 660 were 90+ days delinquent or in foreclosure. By comparison, the Mortgage Bankers Association reports that the serious delinquency rate for subprime loans was *over 28 percent*.[31]

### E. The Community Reinvestment Act did not lead to the foreclosure crisis

Critics of the Community Reinvestment Act ("CRA") claim it caused the crisis by "forcing" lenders to make risky loans to low- and moderate-income families and to communities of color. Yet – even apart from the fact that the CRA requires loans to qualified buyers, not risky ones – most subprime lending was done by financial institutions that are not even subject to CRA requirements. CRA covers banks and thrifts. These institutions did not make many subprime loans. In fact, fully 94 percent of subprime mortgage loans were made by institutions not covered by CRA, or outside the institutions' CRA assessment areas, including affiliates that were excluded from CRA compliance review.[32] Moreover, the CRA was passed in 1977, and was in effect for more than two decades before subprime lending appeared.[33]

Nor can CRA be blamed for the big banks' disastrous investment in mortgage-backed securities backed by subprime loans. These investments were not covered by CRA—

they did not produce CRA credit and were not encouraged by CRA.[34] A 2008 study found that CRA-covered banks were less likely than other lenders to make risky, high-cost loans.[35]

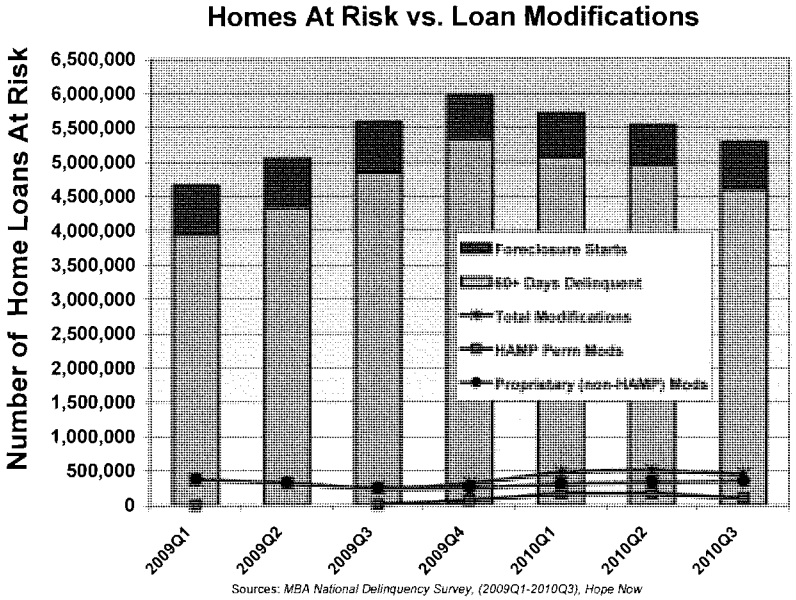
Finally, a report issued by the Federal Reserve Board in 2000 concluded that mortgage loans satisfying the low- and moderate-income element of the CRA's lending test proved to be at least marginally profitable for most institutions, and that many institutions found that CRA lending performed no differently than other lending.[36] Similarly, the experience of community development financial institutions ("CDFIs") serving low- and moderate-income communities, demonstrates that responsible loans in these communities can succeed. A recent report on the FY 2007 performance of community development financial institution ("CDFI") banks—over 71 percent of whose branches are operated in low- to moderate-income communities—found that the majority were profitable. Similarly, community development credit unions had a loan loss rate that was on a par with that of mainstream credit unions.[37]

Those who have studied the issue have concluded, as did John Dugan, former Comptroller of the Currency, that "CRA is not the culprit behind the subprime mortgage lending abuses, or the broader credit quality issues in the marketplace."[38]

### F. Servicer failings have compounded the crisis, producing avoidable defaults and foreclosures.

Despite both HAMP and proprietary modifications, the number of homeowners in foreclosure continues to overwhelm the number of borrowers who have received a permanent loan modification (see Figure 2).

**Figure 2. Demand for Relief Continues to Outpace Loan Modifications**




About 4.6 million mortgages are in foreclosure or 90 days or more delinquent as of June 30.[39] According to the State Foreclosure Prevention Working Group, more than 60 percent of homeowners with serious delinquent loans are still not involved in any loss mitigation activity.[40]

For at least a decade, community-based organizations, housing counselors and advocates nationwide have documented a pattern of shoddy, abusive and illegal practices by mortgage servicers whose staff are trained for collection activities rather than loss mitigation, whose infrastructure cannot handle the volume and intensity of demand, and whose business records are a mess.[41]

These abuses include:

- Misapplication of borrower payments, which results in inappropriate and unauthorized late fees and other charges, as well as misuse of borrower funds improperly placed in "suspense" accounts to create income for servicers.
- Force-placing very expensive hazard insurance and even charging the borrower's account when the borrower's hazard insurance has not lapsed, often driving an otherwise current borrower into delinquency and even foreclosure.
- Charging unlawful default- and delinquency-related fees for property monitoring and broker price opinions.

- Failing or refusing to provide payoff quotations to borrowers, preventing refinancing and short sales.
- Improperly managing borrower accounts for real estate tax and insurance escrows, including failure to timely disburse payments for insurance and taxes, causing cancellation and then improper force-placing of insurance as well as tax delinquencies and tax sales.
- Abuses in the default and delinquency process, including failing to properly send notices of default, prematurely initiating foreclosures during right to cure periods and immediately following transfer from another servicer and without proper notices to borrowers, initiating foreclosure when the borrower is not in default or when the borrower has cured the default by paying the required amount, and failing to adhere to loss mitigation requirements of investors.

These practices have become so ingrained in the servicing culture that they are now endemic in the industry. The harm to which borrowers have been subjected as a result of these abuses cannot be overstated. Numerous homeowners are burdened with unsupported and inflated mortgage balances and have been subjected to unnecessary defaults and wrongful foreclosures even when they are not delinquent. Countless families have been removed from their homes despite the absence of a valid claim that their mortgage was in arrears.

Perverse financial incentives in pooling and servicing contracts explain why servicers press forward with foreclosures when other solutions are more advantageous to both homeowner and investor. For example, servicers are entitled to charge and collect a variety of fees after the homeowner goes into default and can recover the full amount of those fees off the top of the foreclosure proceeds.[42] The problem of misaligned incentives is compounded by a lack of adequate resources, management, and quality control.

What's more, recent legal proceedings have uncovered the servicing industry's stunning disregard of basic due process requirements.[43] Numerous servicers have engaged in widespread fraud in pursuing foreclosures through the courts and, in non-judicial foreclosure states, through power of sale clauses. It is becoming more and more apparent that servicers falsify court documents not just to save time and money, but because they simply have not kept the accurate records of ownership, payments and escrow accounts that would enable them to proceed legally.

## III. QRM regulations should ensure that responsible lending becomes the norm

### A. Requiring mortgage securitizers to retain 5 percent of credit risk is unlikely to meaningfully deter inappropriate lending; the real value of the risk retention rule is in its ability to incentivize lenders to make responsible QRM loans.

Before there were mortgage-backed securities, mortgage lenders retained a relationship with their borrowers throughout the life of the loan and had a clear financial stake in each

borrower's success. This gave lenders strong motivation to confirm that the borrower could afford the required monthly payments and to avoid subjecting the borrower to unmanageable payment increases. It also led lenders to work with borrowers through periods of illness or job loss to ensure that short-term cash-flow shortages did not produce needless defaults. As a consequence, both historically and recently, these "portfolio loans" (loans held in the portfolio of the originating lender) performed significantly better than the securitized loans that were securitized and sold to investors.

Dodd-Frank's risk retention provisions are intended to incentivize lenders to lend more responsibly. Dodd-Frank directs the agencies to define QRM taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default. The statute provides the following examples of the features to be considered: documentation and verification of borrower resources, residual income and debt-to-income ratios, mitigating the potential for payment shock on adjustable rate mortgages, mortgage guarantee insurance or other types of insurance or credit enhancement obtained at the time of origination to the extent they reduce the default risk, and prohibiting or restricting the use of balloon payments, negative amortization, prepayment penalties, interest-only payments and other features demonstrated to have a higher default risk.[44] The three Senate sponsors of the risk retention provisions—Senators Johnny Isakson, Kay Hagan, and Mary Landrieu, D-La—sent a letter to the regulators saying that they intentionally did not include down payment requirements in the QRM.[45]

By directing the regulators to define QRM by characteristics shown to lower default risk, Congress has created the framework for a market in which sensibly underwritten, responsibly structured, competently serviced mortgages are once again the norm. By making these mortgages widely available to all creditworthy families, the rules would protect everyone in the housing finance chain—borrowers, lenders, investors—from the disruptions that occur when irresponsible lending is allowed to flourish. Unfortunately, the proposed rule strays far from Congressional intent.

### B. Requiring large down-payments to obtain a QRM loan would preclude many credit-worthy families from the most sustainable loans—negatively affecting a large proportion of middle class families and a disproportionate number of families of color—without a material improvement in the performance of those loans.

#### 1. Requiring large down-payments would put homeownership beyond much of the middle class, with disproportionate impact on families of color.

Limiting low downpayment loans would unnecessarily close the door to homeownership for middle-class families, and is contrary to Congressional intent.

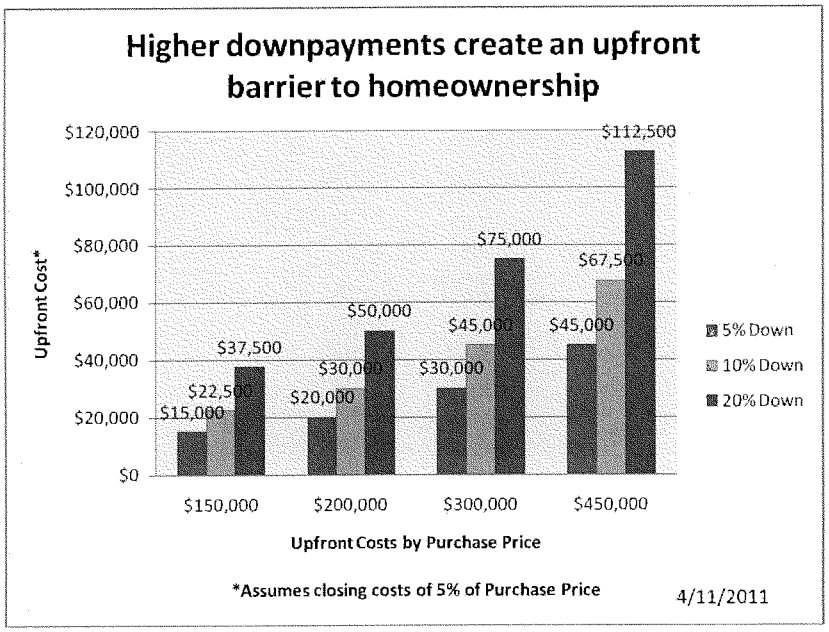
In 2009, the median sales price of a single-family home was $172,100. Even with a substantial savings commitment ($3,000 per year), it would take a middle-income family 14 years to accumulate the cash needed for a 20 percent downpayment.[46]

| | 20% Downpayment | 10% Downpayment | 5% Downpayment |
|---|---|---|---|
| Sales price | $ 172,100 | $ 172,100 | $ 172,100 |
| Cash required at closing (downpayment + 5% closing costs) | $ 43,025 | $ 25,815 | 17,210 |
| Monthly savings amount | $ 250 | $ 250 | $ 250 |
| **Approx. # years required to build downpayment** | **14** | **9** | **6** |

Although $3,000 in savings per year may not sound significant, it represents a personal savings rate of 7.5 percent per year for the average middle class family (2009 real median household income in the U.S. was $49,777.) For Latino and African-American households, this would require savings rates of 9.9 percent and 11.5 percent, respectively.[47] Currently, the savings rate for U.S. households is 5.8 percent, one of the highest savings rates since the early 1990s.[48]

In high cost areas, a large downpayment requirement would be even more problematic for working families. Consider, for example Staten Island, New York, and Oakland, California, where the average listing price for a single-family home is $415,516 (as of 2010)[49] and $484,476 (as of 2011) [50] respectively, requiring minimum downpayments of over $80,000.

As the following chart demonstrates, higher downpayments create barriers to homeownership and the corresponding wealth-building:




The agencies' proposed down-payment requirements for refinance loans are even more extreme—25 percent for refinances in which the homeowner takes no cash out, and 30 percent for so-called "cash out" refinances. This means that a family current on its mortgage payments would barred from refinancing into a lower-cost QRM loan simply because they had less than a 25 percent equity stake in the home. This would disqualify many current homeowners whose equity has been wiped out in the recent crisis, as demonstrated by the examples of varying equity levels among homeowners nationwide and in individual states.

| | Percent of Homeowners with home equity of Less than 30% | Percent of Homeowners with home equity of Less than 25% | Percent of Homeowners with home equity of Less than 20% | Percent of Homeowners with home equity of Less than 10% | Percent of Homeowners with home equity of Less than 5% |
|---|---|---|---|---|---|
| Nation-wide | 57 | 52 | 46 | 34 | 28 |
| Califor-nia | 58 | 54 | 49 | 41 | 36 |
| Florida | 70 | 66 | 63 | 55 | 51 |
| Illinois | 58 | 52 | 46 | 33 | 27 |
| New Jersey | 46 | 41 | 35 | 25 | 21 |

Source: Community Mortgage Banking Project, based on data from CoreLogic Inc.

More than half of current homeowners will be disqualified by the proposed QRM definition from even a rate-reducing refinance loan unless they can come up with a cash downpayment.

For first-time homebuyers, a ten or twenty percent downpayment requirement would pose a severe barrier to market entry. Among renters (from whom the pool of first time homebuyers is drawn), only the wealthiest 25 percent of white, non-Hispanics nationwide have cash savings in excess of about $5,000. For renters of color, only the wealthiest 25 percent have more than $2,000.[51] Even a ten percent downpayment requirement would put homeownership beyond the reach of many creditworthy families who would otherwise have succeeded in homeownership, and built wealth for their families.

**2. Excluding from QRM loans those families lacking sufficient down-payments will come with significant social costs without corresponding benefit to borrowers, investors or the taxpayers.**

Barring creditworthy families from responsible mortgage loans will come with social costs that are not counter-balanced by improvements in the loan loss rates.

Low downpayment loans have been originated safely for over 50 years, but they expanded in volume with the growth of the secondary mortgage market in the 1980s. Over 27 million low downpayment loans were made between 1990 and 2009 (excluding FHA/VA loans).[52] This represents almost one-quarter of the loans purchased by Fannie Mae and Freddie Mac and 13 percent of total mortgage originations during this period. Because of these low downpayment loans, millions of low-to-moderate income families became successful homeowners. These mortgages generally performed well, producing limited losses for lenders, investors and taxpayers, while expanding the middle class.

The risks associated with subprime loans of recent years derived not from the small downpayments so much as from the failure to establish ability to repay beyond the "teaser rate" period of the loan, the failure to document income, and loan features such as explosive interest rate increases and exorbitant prepayment penalties that made it difficult for struggling homeowners to exit the loan. Low downpayment loans without these risky features have generally performed well. Studies have shown that for these responsible loans, low downpayments are not an important driver of default, at least so long as there is some downpayment.[53] In a recent review of loan performance based on various loan attributes, Mark Zandi observed, "Even loans with only 3 percent down at origination have experienced a surprisingly modest 4.7 percent foreclosure rate" during the recent period of extreme financial stress, where the loans were otherwise well structured and underwritten.[54]

The cost side of the ledger includes the prolonging of instability in the housing market. Home sellers need buyers. Impeding market access for creditworthy home buyers will harm existing homeowners who need to sell the home in order to relocate for a job, to accommodate a growing family, or to scale back in retirement. Unduly restricting the

number of possible buyers will make it harder for families to sell their home and harder for them to realize its value.

Another substantial cost will be the loss of homeownership as the most significant wealth-building tool for American families. Beyond the well-documented social and community benefits of owning a home,[55] as a leveraged investment with a built in savings mechanism, homeownership remains the primary way in which American households accumulate wealth.[56] In 2000, home equity accounted for 32.3 percent of aggregate household wealth for all Americans. For families of color, this percentage is even higher: For African Americans, home equity accounted for 61.8 percent of aggregate wealth, and for Hispanics, 50.8 percent.[57] Some recent studies have concluded that for low-income families, not only is homeownership an important means of wealth accumulation, but also for most of these households it is the *only* form of wealth accumulation.[58] Indeed, among households earning between $20,000 and $50,000, those who own homes have 19 times the wealth of those who rent.[59] Overall, real estate holdings comprise the greatest share of assets held by U.S. households.

Restricting access to homeownership based on wealth accumulation will also exacerbate further the wealth gap between Whites and African Americans, which has already *quadrupled* over the course of a single generation.[60]

C. Other QRM provisions are also unduly restrictive and will unnecessarily harm borrowers, investors and the overall economy.

The proposed QRM definition proposes to add a debt to income ratio ("DTI") of 28 percent for mortgage debt and 36 percent for all debt, as well as a restriction of no 60 day delinquencies in the previous two years. While very high debt to income ratios and asset based lending to those unable to pay were contributing factors to high mortgage defaults, we believe the proposed standards are overly restrictive.

Regarding DTI, subprime loans during the crisis regularly permitted DTIs of 50 or 55%. Leaving many families with little residual income for necessary living expenses and makes their mortgages unsustainable. However, the proposed DTI standards are very restrictive, and could be expanded without unnecessary risk.

Likewise with past credit delinquencies, these are a relevant underwriting criterion, but again the proposed standards are overly restrictive. For example, many families have inadequate health insurance and may incur an uninsured medical expense, even though they are very creditworthy. Experience through Self-Help's lending and that of others has shown that such debts are not indicative of risky lending.

CRL is still evaluating data in terms of the exact standards that would be appropriate for these factors. We note that one leading economist, Mark Zandi, of Moodys.com, has also expressed concerns that the proposed standards for these factors are too restrictive and

has suggested debt to income ratios of 33 percent for mortgage debt and 45% for all debt, and a standard of no 90 day delinquencies in the past two years.[61]

**D.The QRM definition should provide for appropriate servicing.**

As demonstrated earlier in this testimony, servicers are failing in their role to serve as intermediaries between borrowers and investors. Some borrowers face default or even foreclosure because of improperly applied payments by servicers, or pay thousands of dollars for force-placed hazard insurance when they already have their own policies. Other borrowers who are truly in default but appear to qualify for modifications are denied (or not even considered for) such modifications because of servicer incapacity, servicer conflicts-of-interests (e.g., when the servicer is the second-lien holder or earns more by foreclosing by imposing fees), or conflicts among investors (e.g., investors overall would do better with a modification rather than a foreclosure, but certain investors would lose).

The QRM definition should include appropriate loan servicing standards, including the requirement that servicers mitigate losses by taking appropriate action to maximize the net present value of the mortgages for the benefit of all investors (rather than any particular investor class). Servicers should also be required to pursue loss mitigation rather than foreclosure where doing so would yield a net present value that is equal or greater than under foreclosure. The structure of servicer compensation must not operate to encourage foreclosure over loss mitigation.

Servicers must be required to implement a reasonable process for addressing subordinate liens owned by the servicer or any of its affiliates. The interests of the first lien-holders on the property should have priority in the resolution of a troubled loan, and servicers holding second liens should have an absolute fiduciary responsibility to act in the best interests of the first lien-holders, regardless of the servicer's other interests in the property. Finally, servicers should be required to publicly disclose their ownership interests (or those of any affiliate) in any other loans secured by the property that secures any loan in the pool.

**Conclusion**

For these reasons, we believe it would be a mistake to build barriers to first-time homeownership into the fundamental structure of the nation's housing finance system, either through the process of GSE reform, through the qualified residential mortgage definition, or in any other way. In fact, Congress enacted the QRM safe harbor within the 5% risk retention rule to ensure that most borrowers would be served by well-structured, responsibly underwritten and appropriately serviced mortgage loans. The QRM definition should be restructured so that such loans would become widely available to all credit-worthy families. Unfortunately, under the current proposal, the QRM definition would recreate a two-tiered credit market, relegating many creditworthy families to second-tier, less sustainable mortgage loans. Access to responsibly structured

properly serviced loans is particularly important for families who lack the wealth to sustain payment shock or hedge against interest rate risk.

Barring these families from access to responsible loans would reinforce an unfair, separate and unequal housing finance system that would relegate underserved families to FHA or to higher cost, less desirable lending channels – or even exclude them entirely from homeownership they could otherwise sustain. Creditworthy borrowers should not be limited to FHA or to loans that do not meet QRM standards simply because they cannot make a large downpayment or meet overly restrictive debt to income and credit history requirements. Middle class families should not be denied creditworthy families to purchase their homes. That is not good for homeowners or for the health of the overall market. As a result, we strongly urge regulators to revise the proposed rule in the manner outlined in this testimony.

We appreciate the chance to testify today and look forward to continuing to work with Congress and regulators on these crucial issues.

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[1] Laurie Goodman, Roger Ashworth, Brian Landy, and Lidan Yang, "The Housing Crisis—Sizing the Problem, Proposing Solutions," Amherst Mortgage Insight (Oct. 1, 2010) [hereinafter "Amherst Study," on file with CRL.

[2] MBA National Delinquency Survey, August 2010 [hereinafter "MBA National Delinquency Survey"]. The combined percentage of loans in foreclosure or at least one payment past due was 13.7 percent on a non-seasonally adjusted basis.

[3] This is for Q4 2010 and can be found at Zillow's Real Estate Market Reports at zillow.com. Another source is the First American Core Logic Negative Equity Report, which has reported similar statistics and whose Q4 2010 report should be out in a few weeks.

[4] Rod Dubitsky, Larry Yang, Stevan Stevanovic and Thomas Suehr, *Foreclosure Update: over 8 million foreclosures expected,* Credit Suisse (Dec. 4, 2008) (projecting 10 million foreclosures by 2012 depending on current unemployment rates); Jan Hatzius and Michael A. Marschoun, *Home Prices and Credit Losses: Projections and Policy Options*, Goldman Sachs Global Economics Paper (Jan. 13, 2009) (projecting 13 million foreclosures by 2014) at 16.

[5] Debbie Gruenstein Bocian, Wei Li, and Keith S. Ernst, "Foreclosures by Race and Ethnicity: The Demographics of a Crisis," Center for Responsible Lending (June 18, 2010), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosures-by-race-and-ethnicity.pdf.

[6] For methodology, *see* Center for Responsible Lending, "Soaring Spillover: Accelerating Foreclosures to Cost Neighbors $502 Billion in 2009 Alone; 69.5 Million Homes Lose $7,200 on Average; Over Next Four Years, 91.5 Million Families to Lose $1.9 Trillion in Home Value; $20,300 on Average" (May 2009), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/soaring-spillover-3-09.pdf.

[7] Center for Responsible Lending, *Continued Decay and Shaky Repairs: The State of Subprime Loans Today* (Jan. 8, 2009), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/continued_decay_and_shaky_repairs.pdf.

[8] G. Thomas Kingsley, Robin Smith, & David Price, *The Impact of Foreclosures on Families and Communities*, The Urban Institute (May 2009), at 21, Fig. 3.

[9] D. Pelletiere, "Renters in Foreclosure: Defining the Problem, Identifying Solutions," National Low-Income Housing Coalition (Jan. 2010), *available at* http://dsl-router.nlihc.org/doc/renters-in-foreclosure.pdf.

[10] The "Helping Families Save Their Home Act of 2000," signed into law by President Obama in May 2009, provided that month-to-month tenants must receive 90 days' notice before having to move out and that tenants with leases may stay until the end of their lease (unless the owner plans to occupy the property, in which case tenants still must receive 90 days notice).

[11] Also, many tenants are not aware of their right to stay in their homes, and when they receive a notice from a bank lawyer naming their landlord and seeking eviction, they leave regardless of their legal rights. *See, e.g.,* Testimony of Deborah Cuevas Hill, The Legal Aid Society of the District of Columbia, before the Committee on Public Services and Consumer Affairs, Council of the District of Columbia (May 28, 2009), *available at* http://www.legalaiddc.org/issues/documents/TestimonyreTOPALegilsation.pdf.

[12] "Meeting Multifamily Finance Housing Needs During and After the Crisis: A Policy Brief," Joint Center for Housing Studies, Harvard University (Jan. 2009), *available at* http://www.jchs.harvard.edu/publications/finance/multifamily_housing_finance_needs.pdf.

[13] *Id.*

[14] It is popular, although incorrect, to blame the Community Reinvestment Act (CRA) and Fannie Mae and Freddie Mac (the GSEs) for the foreclosure crisis. For a complete discussion of why CRA and the GSEs did not cause the crisis, *see* Testimony of Eric Stein, Center for Responsible Lending, before the Senate Committee on Banking (Oct. 16, 2008), *available at* http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/senate-testimony-10-16-08-hearing-stein-final.pdf.

[15] These were loans with the following characteristics: debt-to-income ratios lower than 41percent; fixed rate or loans with at least a 7 year fixed period; a term of 30 years or less; no balloon payments; no interest-only or negative amortization loans; full income documentation; and either an LTV under 80percent or, if LTV above 80percent, with mortgage insurance.

[16] Vertical Capital Solutions, Historical Performance of Qualified vs. Non-Qualified Mortgage Loans (February 2010) (on file with CRL).

[17] Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy: As Housing Boomed, Industry Pushed Loans To a Broader Market*, Wall Street Journal at A1 (Dec. 3, 2007).

[18] Letter from Coalition for Fair & Affordable Lending to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner (Jan. 25, 2007) at 3.

[19] *See e.g.,* Yuliya Demyanyk, "Ten Myths About Subprime Mortgages," Economic Commentary, Federal Reserve Bank of Cleveland (May 2009) *available at* http://www.clevelandfed.org/research/commentary/2009/0509.pdf; Karen Weaver, "The Sub-Prime Mortgage Crisis: A Synopsis," Deutsch Bank (2008) *available at* http://www.globalsecuritisation.com/08_GBP/GBP_GSSF08_022_031_DB_US_SubPrm.pdf (concluding that subprime mortgages "could only perform in an environment of continued easy credit and rising home prices).

[20] Lei Ding, Roberto G. Quercia, Janneke Ratcliff, and Wei Li, "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models," Center for Community Capital, University of North Carolina at Chapel Hill (Sept. 13, 2008), *available at* http://www.ccc.unc.edu/abstracts/091308_Risky.php.

[21] Center for Responsible Lending, *Steered Wrong: Brokers, Borrowers and Subprime Loans* (April 8, 2008), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/steered-wrong-brokers-borrowers-and-subprime-loans.pdf.

[22] *Id.*

[23] R.B. Avery, G.B. Canner, and R.E. Cook, Summer 2005. "New Information Reported under HMDA and Its Application in Fair Lending Enforcement," Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2005/summer05_hmda.pdf); R.B. Avery, K.P. Brevoort, and G.B. Canner, September 2006. "Higher-Priced Home Lending and the 2005 HMDA Data," Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf); R.B. Avery, K.P. Brevoort, and G.B. Canner, December 2007. "The 2006 HMDA Data" Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf); R.B. Avery, K.P. Brevoort, G.B. Canner, December 2008. "The 2007 HMDA Data", Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07final.pdf); R.B. Avery, K.P. Brevoort, G.B. Canner, September 2009, "The 2008 HMDA Data", forthcoming in Federal Reserve Bulletin (available at http://www.federalreserve.gov/pubs/bulletin/2009/pdf/hmda08draft2.pdf). *See also* Debbie Gruenstein Bocian, Keith Ernst and Wei Lee, "Race, Ethnicity and Subprime Loan Pricing." Journal of Economies and Business, Vol. 60, Issues 1-2, January-February 2008, at 110-124; Debbie Gruenstein Bocian and Richard Zhai, "Borrowers in High Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans,"January 2005, available at http://www.responsiblelending.org/mediacenter/press-releases/archives/rr004-PPP_Minority_Neighborhoods-0105.pdf

[24] *Supra* note 5.

[25] Debbie Gruenstein Bocian, Peter Smith, Ginna Green and Paul Leonard, "Dreams Deferred: Impacts and Characteristics of the California Mortgage Crisis." Center for Responsible Lending (August 2010), *available at* http://www.responsiblelending.org/california/ca-mortgage/research-analysis/dreams-deferred-CA-foreclosure-report-August-2010.pdf.

[26] According to the 2007 Survey of Consumer Finance, the median net worth for white, non-Hispanic families in 2007 was $171,200, compared to $28,300 for families of color. *See* Table 4 of the Survey of Consumer Finance (Tables based on Internal Data, Estimates in Nominal Dollars), *available at* http://www.federalreserve.gov/PUBS/oss/oss2/2007/scf2007home.html.

[27] See Fannie Mae Single Family Selling Guide, *available at* http://www.allregs.com/efnma/index.asp?dv=0&id=a&ii=0&im=0&io=fnma&ip=/&iq=0&iv=0&iw=0&iy=0&iz=0&fc=0&fk=_&fm=0&fs=0&fv=0&sd=/&sm=1&sp=fnma&sq=_&st=_&sv=0&sx=/&sy=0&sz=0&t=0&tc=fnma&tp=/&td=0&ti=0&tm=0&to=fnma&tw=0&tv=0&tq=0&tx=/; Freddie Mac Seller/Servicer Guide, available at http://www.freddiemac.com/sell/guide/#.

[28] *Inside the GSEs*, January 3, 2007, p. 4. These securities are divided into tranches, with the AAA tranches being the least risky, and for this reason the easiest to sell to investors. Fannie Mae and Freddie Mac purchased only AAA tranches. The harder securities to sell are those from the subordinate tranches. These were made palatable to investors through the creation of collateralized debt obligations, which repackaged BBB tranches into, in part, a new set of AAA tranches, which help to further market the seeurities; to my knowledge the GSEs did not invest in CDOs. It was the ability to fund the riskiest portion of subprime mortgage loans that made possible the explosive growth of subprime lending. See Pershing Square Capital Management, L.P., "Who's Holding the Bag," presentation, May 2007, available at http://www.designs.valueinvestorinsight.com/bonus/pdf/IraSohnFinal.pdf.

[29] See David Goldstein and Kevin G. Hall, "Private sector loans, not Fannie or Freddie, triggered crisis," McClatchy Newspapers (Oct. 11, 2008) ("Between 2004 and 2006, when subprime lending was exploding, Fannie and Freddie went from holding a high of 48 percent of the subprime loans that were sold into the

secondary market to holding about 24 percent, according to data from Inside Mortgage Finance, a specialty publication. One reason is that Fannie and Freddie were subject to tougher standards than many of the unregulated players in the private sector who weakened lending standards, most of whom have gone bankrupt or are now in deep trouble. During those same explosive three years, private investment banks—not Fannie and Freddie—dominated the mortgage loans that were packaged and sold into the secondary mortgage market. In 2005 and 2006, the private sector securitized almost two thirds of all U.S. mortgages, supplanting Fannie and Freddie, according to a number of specialty publications that track this data.") available at http://www.mcclatchydc.com/251/story/53802.html.

[30] Fannie Mae, Investor presentation, "Fannie Mae 2008 Q2 10-Q Investor Summary," (Aug. 6, 2008), p.36, available at: http://www.fanniemae.com/media/pdf/webcast/080808transcript.pdf. By the middle of 2008, Alt-A loans accounted for roughly 10percent of Fannie Mae and Freddie Mac's risk exposure, but 50percent of their combined losses. Federal National Mortgage Association, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, p.6, available at http://www.fanniemae.com/ir/pdf/earnings/2008/q22008.pdf; Federal Home Loan Mortgage Corporation, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, p.71, available at http://www.freddiemac.com/investors.

[31] Kevin Park, "Fannie, Freddie and the Foreclosure Crisis," University of North Carolina Center for Community Capital (Sept. 2010), available at http://www.ccc.unc.edu/documents/FannieFreddieForeclosure.pdf at 4.

[32] Staff Analysis of the Relationship between the CRA and the Subprime Crisis, Nov. 21, 2008, Board of Governors of the Federal Reserve, Division of Research and Statistics (available at http://www.federalreserve.gov/newsevents/speech/20081203_analysis.pdf).

[33] For further discussions of how CRA has aided rather than harmed communities, *see* Janet L. Yellen, Opening Remarks to the 2008 National Interagency Community Reinvestment Conference, San Francisco, California (March 31, 2008) (noting that studies have shown that the CRA has increased the volume of responsible lending to low- and moderate-income households); Ann F. Jaedicke, Testimony Before the Committee on Financial Services, US House of Representatives (February 13, 2008) ("over half of subprime mortgages of the last several years—and the ones with the most questionable underwriting standards—were originated through mortgage brokers for securitization by nonbanks, including major investment banks"); Michael S. Barr, *Credit Where It Counts: Maintaining a Strong Community Reinvestment Act,* Brookings Institution Research Brief (May 2005) ("encouraged by the law, banks and thrifts have developed expertise in serving low-income communities.").

[34] Federal Register Vol. 75, No. 47 (Mar. 11, 2010 ) at 11652 ("As a general rule, mortgage backed securities and municipal bonds are not qualified investments because they do not have as their primary purpose community development, as defined in the CRA regulations.")

[35] See Traiger & Hinckley LLP, The Community Reinvestment Act: A Welcome Anomaly in the Foreclosure Crisis: Indications that the CRA Deterred Irresponsible Lending in the 15 Most Populous U.S. Metropolitan Areas, Jan. 8, 2008, *available at* http://www.traigerlaw.com/publications/traiger_hinckley_llp_cra_foreclosure_study_1-7-08.pdf.

[36] Board of Governors of the Federal Reserve System, "The Performance and Profitability of CRA-Related Lending, A report submitted to Congress pursuant to Section 713 of the Gramm-Leach-Bliley Act of 1999." (July, 17, 2000) at 45-46, www.federalreserve.gov/boarddocs/surveys/craloansurvey/cratext.pdf; see also "CRA Special Lending Programs," Avery, Bostic and Canner, Federal Reserve Bulletin (Nov. 2000) at 723, www.federalreserve.gov/pubs/bulletin/2000/1100lead.pdf (Ninety-three percent of responding CRA-covered institutions so reported).

[37] The CDFI Data Project, Fiscal Year 2007, Seventh Edition, "Providing Capital, Building Communities, Creating Impact" http://www.opportunityfinance.net/industry/industry_sub1.aspx?id=248.

[38] Press release issued on November 19, 2008, quoting Mr. Dugan in a speech to the Enterprise Annual Network Conference.

[39] Based on MBA Delinquency Survey for 2010 Q2, adjusted to reflect MBA's estimated 88percent market coverage.

[40] *Supra* note 3.

[41] *See e.g. In re Ocwen Loan Servicing, LLC Mortg. Servicing Litigation,* 491 F.3d 638 (7th Cir. 2007) (allegations by a class of homeowners that Ocwen systematically charged late fees for payments that were sent on time); *Federal Trade Commission (FTC) Settlement* (2003) resulted in $40 million for consumers harmed by illegal loan servicing practices, *available at* http://www.ftc.gov/fairbanks (FTC alleged, among other things, that Fairbanks illegally charged homeowners for "forced placed insurance" and violated the Fair Debt Collection Practices Act); and *FTC Settlement with Countrywide, available at* http://www.ftc.gov/countrywide (Countrywide agreed to pay $108 million dollars to homeowners in response to the FTC's allegations that Countrywide charged illegal fees to homeowners during Chapter 13 bankruptcy proceedings).

[42] For a thorough discussion of the servicing incentive structure, see Testimony of Diane Thompson before the Senate Banking Committee (Nov. 16, 2010), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=df8cb685-c1bf-4eea-941d-cf9d5173873a&Witness_ID=d9df823a-05d7-400f-b45a-104a412e2202 ; *see also* Diane Thompson, "Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior," National Consumer Law Center (Oct. 2009), *available at* http://www.nclc.org/images/pdf/foreclosure_mortgage/mortgage_servicing/servicer-report1009.pdf.

[43] The Center for Responsible Lending is serving as co-counsel in several cases relating to these issues, including a Maine class action, *Bradbury et al v. GMAC Mortgage, LLC* (Civil Action, Docket CV-2010-494, U.S. Dist. ME). In a related individual case, US Bank v. James (Civil Action, Docket CV-2009-0084, U.S. Dist. ME, Doc. 196 1/31/11), the court recently awarded sanctions to a homeowner required to defend against a motion for summary judgment supported by a falsely sworn affidavit (robo-signing) ruling, "Stephan's actions in this case strike at the heart of any court's procedures, are egregious under the circumstances, and must be deemed worthy of sanctions."

[44] Dodd-Frank sec. 941(b).
[45] See February 16, 2011 letter from Senators Landrieu, Hagan and Isakson to the QRM regulators stating "although there was discussion about whether the QRM should have a minimum down payment, in negotiations during the drafting of our provision, we intentionally omitted such a requirement." See also February 11, 2011 op-ed by Sen. Isakson in The Hill: "In fact, we debated and specifically rejected a minimum down payment standard for the Qualified Residential Mortgage."
[46] The calculation assumes interest paid on savings is offset by increase in home prices.
[47] African-American and Latino 2009 household median incomes were $32,584 and $38,039, respectively. The calculation assumes 15percent federal tax rate and 5percent state tax rate.
[48] U. S. Bureau of Economic Analysis.
[49] Trulia Staten Island Real Estate Overview, http://www.trulia.com/real_estate/Staten_Island-New_York/
[50] Trulia Oakland Real Estate Overview, http://www.trulia.com/real_estate/Oakland-California/
[51] Harvard University Joint Center for Housing Studies tabulations of 2007 Survey of Consumer Finances.
[52] Private mortgage insurance volume as reported by Inside Mortgage Finance Mortgage Market 2009 Statistical Annual
[53] Zandi, The Skinny on Skin in the Game at 3.
[54] Id.
[55] These include better educational achievement (including higher high school graduation rates and higher rates of post-secondary education), and more stable communities. *See* Christopher E. Herbert and Eric S.

Belsky, "The Homeownership Experience of Low-Income and Minority Households: A Review and Synthesis of the Literature," Cityscape: A Journal of Policy Development and Research, Vol. 10, No. 2, U. S. Dep't of Housing and Urban Development, Office of Policy Development and Research (2008) at 40, 43-46; *see also* Raphael Bostic and Kwan Ok Lee, "Homeownership: America's Dream" (Oct. 2007) at 10 (surveying literature).

[56] Testimony by Janneke Ratcliffe, UNC Center for Community Capital before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, US House of Representatives, Hearing on Future of Housing Finance: The Role of Private Mortgage Insurance. July 29, 2010.

[57] Christopher E. Herbert and Eric S. Belsky, The Homeownership Experience of Low-Income and Minority Households: A Review and Synthesis of the Literature, Cityscape: A Journal of Policy Development and Research, Vo. 10, No. 2, U. S. Dep't of Housing and Urban Development, Office of Policy Development and Research (2008) at 8, citing Orzechowski and Sepielli (2003).

[58] Herbert & Belsky (2008) at 40 (citing Boehm and Schlottmann (1999, 2004c)).

[59] The State of the Nation's Housing 2010. Joint Center for Housing Studies.

[60] Thomas M. Shapiro, Tatjana Meschede, and Laura Sullivan, "The Racial Wealth Gap Increases Fourfold," Institute on Assets and Social Policy, Research and Policy Brief (May 2010) at 1 (citing data from the Panel Survey of Income Dynamics and noting that the wealth gap had quadrupled over the last 25 years).

Zandi, The Skinny on Skin in the Game" http://www.economy.com/mark-zandi/documents/QRM_030911.pdf]

**TESTIMONY OF J. CHRISTOPHER HOEFFEL ON BEHALF OF THE COMMERCIAL REAL ESTATE FINANCE COUNCIL**

**Before the**
**UNITED STATES HOUSE FINANCIAL SERVICES COMMITTEE**
**SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES**

**HEARING ON: "UNDERSTANDING THE IMPLICATIONS AND CONSEQUENCES OF THE PROPOSED RULE ON RISK RETENTION"**

**APRIL 14, 2011**

The Commercial Real Estate (CRE) Finance Council is grateful to Chairman Garrett, Ranking Member Waters, and the Members of the Subcommittee for holding this hearing to examine the implications and consequences of the proposed risk retention rule on our nation's credit markets. The CRE Finance Council represents all constituencies in the broader CRE finance market, and we appreciate the opportunity to share our views on the proposed rule as it pertains to the commercial real estate market.

## Introduction & Overview

The $7 trillion commercial real estate market in the United States is just emerging from a period in which it faced serious duress brought on by the severe economic downturn, and significant hurdles remain to recovery in the near term. The challenges posed by the distress the CRE market has experienced will continue to have an impact on U.S. businesses that provide jobs and services, as well as on millions of Americans who live in multifamily housing. Since 2009, the CRE problem shifted from a crisis of confidence and liquidity to a crisis of deteriorating commercial property fundamentals, plummeting property values and rising defaults. In the next few years alone, over $1 trillion in outstanding commercial mortgages will mature and borrower demand to refinance those obligations will be at an all-time high.

Prior to the onset of the economic crisis, commercial mortgage-backed securities ("CMBS") were the source of approximately half of all CRE lending, providing approximately $240 billion in capital to the CRE finance market in 2007 alone. After plummeting to a mere $2 billion in 2009 at the height of the crisis, the CMBS market began to see signs of life in 2010 with $12.3 billion in issuance, and issuance in 2011 is expected to range from $30 to $50 billion, depending on a number of factors including economic conditions and the manner in which regulatory and accounting changes are implemented.

One of the overarching questions faced at this juncture is whether CMBS will be able to continue to help to satisfy the impending capital needs posed by the refinancing obligations that are coming due. Without CMBS, there simply is not enough balance sheet capacity available through traditional portfolio lenders such as banks and life insurers to satisfy these demands. It is for this reason that Treasury Secretary Geithner noted two years ago that "no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to businesses – large and small." [1]

[1] Remarks by Treasury Secretary Timothy Geithner Introducing the Financial Stability Plan (Feb. 10, 2009) (available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ahSJwkdThtlo).

Similarly, then-Comptroller of the Currency John C. Dugan noted that, "[i]f we do not appropriately calibrate and coordinate our actions, rather than reviving a healthy securitization market, we risk perpetuating its decline – with significant and long-lasting effects on credit availability."[2]

Against this backdrop, Congress adopted a credit risk retention framework for asset-backed securities in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[3] and the proposed rule being discussed today would implement that risk retention framework.[4] Prior to the issuance of the proposed rule, the Board of Governors of the Federal Reserve issued a "Report to the Congress on Risk Retention" as required under a Dodd-Frank provision authored by Chairman Garrett, and the Board concluded that:

> [S]imple credit risk retention rules, applied uniformly across assets of all types, are unlikely to achieve the stated objective of the Act—namely, to improve the asset-backed securitization process and protect investors from losses associated with poorly underwritten loans … the Board recommends that rulemakers consider crafting credit risk retention requirements that are tailored to each major class of securitized assets. Such an approach could recognize differences in market practices and conventions, which in many instances exist for sound reasons related to the inherent nature of the type of asset being securitized. Asset class–specific requirements could also more directly address differences in the fundamental incentive problems characteristic of securitizations of each asset type, some of which became evident only during the crisis.[5]

The proposed regulations attempt to address this construct by offering different options for satisfying the retention requirements (e.g., vertical, horizontal, and L-shape retention structures) and providing asset-class-specific options, such as those afforded to CMBS, to satisfy the retention mandate. As a community, our members appreciate the efforts to create rules by asset class, given the unique nature of the CMBS market.

At the same time, the proposed risk retention regulations are complex, and we are in the process of studying and discussing them with the different CMBS constituencies included under the CRE Finance Council umbrella (including lenders, issuers, servicers, and investors, among others) in order to fully evaluate their potential impact and to provide useful feedback to regulators on their proposal. As

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[2] Remarks by John C. Dugan, Comptroller of the Currency, before the American Securitization Forum (Feb. 2, 2010), at 2 (available at http://www.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/CMSA_Issues/TALF_Treasury_Plans/DuganRemarksatASF2010.pdf. ).

[3] Pub. L. No. 111-203.

[4] Proposed Rule, Credit Risk Retention, Federal Deposit Insurance Corporation et al., FDIC Docket No. 2011-___, RIN 3064-AD74 (rel. Mar. 29, 2011), (hereafter, "Risk Retention NPRM") (available at http://www.fdic.gov/news/board/29Marchno2.pdf).

[5] Board of Governors of the Federal Reserve System, Report to the Congress on Risk Retention (October 2010), at 3 (available at http://www.federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf).

the Board's Report went on to note, the totality of the regulatory changes that are being put into motion – including the various new disclosure and credit rating agency reform provisions in Dodd-Frank, the accounting changes that must be effectuated, and the new Basel capital requirements regime – must be considered *in toto* in making this evaluation:

> [R]ulemakings in other areas could affect securitization in a manner that should be considered in the design of credit risk retention requirements. Retention requirements that would, if imposed in isolation, have modest effects on the provision of credit through securitization channels could, in combination with other regulatory initiatives, significantly impede the availability of financing. In other instances, rulemakings under distinct sections of the Act might more efficiently address the same objectives as credit risk retention requirements.[6]

Viewed through this lens, there are elements of the proposed retention regime that raise potential concerns in the market and, overall, the proposed rule has prompted more questions than it answers. Three portions of the proposal have drawn particularly acute scrutiny from our members:

- First, the insertion of an unexpected "Premium Capture Reserve Account" provision that generally would prohibit bond issuers from monetizing profits when the bonds are issued has raised numerous questions about the intent of the provision and how it would operate in practice, as well as whether the requirement itself could greatly restrict overall CMBS credit availability.

- Second, the CMBS-specific "B-piece buyer" provisions that would permit the retention obligation to be borne by third-party investors if certain specified additional obligations are satisfied. For example, an "Operating Advisor" would be required to be added as an extra layer of servicing accountability to the most common CMBS deal structures. This has raised a broad array of questions and concerns that range from whether the provision is strong enough to whether it is needed at all.

- Third, the proposed regulations include "qualifying" CRE loan requirements designed to identify low-risk loans that, if satisfied, would exempt such loans from any retention requirements. Unfortunately, it appears that extremely few, if any, outstanding CMBS loans would satisfy the "qualifying" criteria and consequently, it is unclear whether the entire exemption concept will have any practical import. At the same time, the retention regime overall appears to be designed primarily for "conduit" securitizations through which as many as 200-300 individual loans typically were securitized in the CMBS space. That overlooks the growing and critical segment of the market oriented toward single-borrower and large loan deals, which some estimate to be as much as 50 percent of the market for CMBS lending. The "qualifying CRE loan" provisions may be an ideal place to address those and other similar market segments.

As the regulatory process moves forward, many will argue that implementing certain requirements – or the failure to implement certain requirements – will be a death knell for the market.

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[6] *Id.* at 84.

The more likely outcome is that the failure to get the details right will restrict capital that is available through the securitization finance markets. The proposed rule imposes additional costs on and will – in some cases – disincentivize issuers, and disrupt the efficient execution of capital structures that securitization provides.

Of particular concern are the potential effects of the proposed rule that could lead to a significantly smaller secondary market, less credit availability, and increased cost of capital for CMBS borrowers. Another major concern is that lending on balance sheet (i.e., portfolio lending) may be able to offer more competitive rates, thus attracting the safest risks to the portfolio space, leaving the smaller and/or less safe risks for CMBS where borrowers would have to pay higher rates. Further, small borrowers – those that are not concentrated in the major urban areas and that need loans in the sub-$10 million space – would be the primary victims of these changes. For these reasons, 23 separate trade organizations, representing many different types of borrower constituencies, as well as lenders and investors in different asset classes, jointly signed a letter last year urging careful consideration of the entirety of the reforms to ensure that there is no disruption or shrinkage of the securitization markets.[7]

At the same time, the CRE finance industry also has taken direct steps to strengthen the CMBS market and to foster investor confidence through the development of "market standards" in the areas of representations and warranties; underwriting principles; and initial disclosures. Scores of members of the CRE Finance Council across all of the CMBS constituencies worked diligently on these market reforms for more than a year. The CRE Finance Council anticipates that new market standards, coupled with the unparalleled disclosure regime that already was in place, will create increased transparency and disclosure in underwriting and improved industry representations and warranties, all of which we believe will go a long way toward meeting both investor demands and Dodd-Frank objectives.

As our members continue to work through the proposed rule to better crystallize our views, we cannot overstate the stakes, given that this rule will directly impact credit availability and an overall economic recovery. As noted at the outset, the stakes are high. The agencies need to satisfy the somewhat arbitrarily-imposed Congressionally-mandated rule promulgation schedule, and we are concerned that the ultimate judgments they reach may not be as soundly thought through as a more generous schedule would allow. We therefore ask that Congress consider extending those deadlines; this may be especially appropriate given the fact that under the Dodd-Frank implementation provision, the rules for non-residential asset-backed securities would not go into effect for an additional two years[8] and our industry could still abide by that final effective date even if more time were allotted prior to finalizing the actual rules.

The balance of our testimony will focus on five key areas:

(1) A description of the CRE Finance Council and its unique role;

(2) The current state of CRE finance, including the challenges that loom for the $3.5 trillion in outstanding CRE loans;

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[7] A copy of the March 25, 2010 letter is attached.

[8] Dodd-Frank, § 941(b) (adding Securities Exchange Act § 15G (i)(2)).

(3) The unique structure of the commercial mortgage market and the importance of having customized regulatory reforms, as contemplated in Dodd-Frank, to support, and not undermine, our nation's economic recovery;

(4) The CRE Finance Council's general reactions to the recently proposed regulation to implement Dodd-Frank's risk retention requirement; and

(5) The CRE Finance Council's market standards initiatives, which have been designed to build on existing safeguards in our industry, to promote certainty and confidence that will support a timely resurgence of the CRE finance market in the short term, and a sound and sustainable market in the long term.

**Discussion**

**1. The CRE Finance Council**

The CRE Finance Council is the collective voice of the entire $3.5 trillion commercial real estate finance market, including portfolio, multifamily, and CMBS lenders; issuers of CMBS; loan and bond investors such as insurance companies, pension funds and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers.

Our principal missions include setting market standards, facilitating market information, and education at all levels, particularly related to securitization, which has been a crucial and necessary tool for growth and success in commercial real estate finance. To this end, we have worked closely with policymakers in an effort to ensure that legislative and regulatory actions do not negate or counteract economic recovery efforts in the CRE market. We will continue to work with policymakers on this effort, as well as our ongoing work with market participants and policymakers to build on the unparalleled level of disclosure and other safeguards that exist in the CMBS market, prime examples of which are our "Annex A" initial disclosure package, and our Investor Reporting Package™ ("IRP") for ongoing disclosures.

While the CMBS market is very different from other asset classes and is already seeing positive developments, the CRE Finance Council is committed to building on existing safeguards, to promote certainty and confidence that will support a timely resurgence in the short term and a sound and sustainable market in the long term. In this regard, we have worked with market participants to develop mutually agreed upon improvements needed in the CRE finance arena that will provide an important foundation for industry standards. Prime examples of our work include both the CRE Finance Council's "Annex A" initial disclosure package and the Investor Reporting Package™ for ongoing disclosures.

Furthermore, our members across all constituencies have devoted an extraordinary amount of time over the past year to working collaboratively and diligently on the completion of market standards for: (1) Model Representations and Warranties; (2) Underwriting Principles; and (3) Annex A revisions, all of which we previously have shared with the regulators charged with implementing the Dodd-Frank risk retention rules: the Securities and Exchange Commission, Federal Reserve Board, Federal Deposit Insurance Corporation, Department of the Treasury, and the Office of the Comptroller of the Currency. We anticipate that these three new market standards initiatives, along with the unparalleled ongoing disclosure offered by our existing IRP, will create increased transparency and disclosure in underwriting and improved industry representations and warranties, which we believe will go a long way toward meeting both investor demands and Dodd-Frank objectives.

2. **The Current State of CRE Finance**

CRE is a lagging indicator that is greatly impacted by macroeconomic conditions, and as such, began to be affected by the prolonged economic recession relatively late in the overall economy's downward cycle. What started as a "housing-driven" recession due to turmoil in the residential/subprime markets (in which credit tightened severely) quickly turned into a "consumer-driven" recession, impacting businesses and the overall economy. Not surprisingly, CRE has come under strain in light of the economic fundamentals today and over the last three years, including poor consumer confidence and business performance, high unemployment and property depreciation. Unlike previous downturns, the stress placed on the CRE sector today is generated by a "perfect storm" of several interconnected challenges that compound each other and that, when taken together, has exacerbated the capital crisis and will prolong a recovery:

- **Severe U.S. Recession.** – With a prolonged recession and an unemployment rate at or above 8.8% for the last 24 months, there is no greater impact on CRE than jobs and the economy, as commercial and multifamily occupancy rates, rental income, and property values have subsequently been severely impacted and perpetuate the downturn. Those impacts persist even as the recession has abated.

- **"Equity Gap."** – During the worst of the economic crisis, our industry saw CRE assets depreciate in value by 30% to 50% from 2007 levels, creating an "equity gap" between the loan amount and the equity needed to extend or re-finance a loan, which impacted even "performing" properties that had continued to support the payment of monthly principal and interest on the underlying loans. While there has been some lessening of the equity gap in the past year as the slide in property values slowed, the market is at a sensitive point on the climb toward recovery and a shortage of capital at this stage could cause a resurgence of the equity gap problem.

- **Significant Loan Maturities.** – Approximately $1 trillion in CRE loans mature over the next several years, but perhaps most significantly, many of those loans will require additional "equity" to refinance given the decline in CRE asset values

- **CMBS Restarting, Slowly.** – Even in normal economic conditions, the primary banking sector lacked the capacity to meet CRE borrower demand. That gap has been filled over the course of the last two decades by securitization (specifically, commercial mortgage-backed securities) which utilizes sophisticated private investors – pension funds, mutual funds, and endowments, among others – who bring their own capital to the table and fuel lending. CMBS accounts, on average, for approximately 25% of all outstanding CRE debt, and as much as 50% at the peak, with readily identifiable properties funded by CMBS in every state and Congressional district. However, a prolonged liquidity crisis caused the volume of new CRE loan originations and thus of new CMBS to plummet from $240 billion in 2007 (when CMBS accounted for half of all CRE lending) to $12 billion in 2008, and $2 billion in 2009. In 2010, the CMBS market began to see signs of life with $12.3 billion in issuance, while issuance is expected to range between $30 and $50 billion in 2011, depending upon a number of economic conditions and uncertainty related to regulatory and accounting changes. While there is revitalized activity in the CMBS space, there is a mismatch between the types of loans that investors are

willing to finance and the refinancing that existing borrowers are looking for to extend their current loans.

Although the market has evolved from the initial liquidity crisis, there is still an unfortunate combination of circumstances that leave the broader CRE sector and the CMBS market with three primary problems: 1) the "equity gap" (again, the difference between the current market value of commercial properties and the debt owed on them, which will be extremely difficult to refinance as current loans mature), as previously discussed; 2) a hesitancy of lenders and issuers to take the risk of trying to make or "aggregate" loans for securitization, given the uncertainty related to investor demand to buy such bonds (this 3-6 month "pre-issuance" phase is known as the "aggregation" or "warehousing" period); and 3) the tremendous uncertainty created by the multitude of required financial regulatory changes, which serve as an impediment to private lending and investing, as the markets attempt to anticipate the impact these developments may have on capital and liquidity. Indeed, market analysts have concluded that regulatory uncertainty will likely delay recovery of the securitization markets, including one observer that recently concluded that the delay would be at least another twelve months.[9]

The importance of the securitized credit market to economic recovery has been widely recognized. Both the previous and current Administrations share the view that "no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small."[10] The importance of restoring the securitization markets is recognized globally as well, with the International Monetary Fund noting in a 2009 Global Financial Stability Report that "restarting private-label securitization markets, especially in the United States, is critical to limiting the fallout from the credit crisis and to the withdrawal of central bank and government interventions."[11]

Significantly, it is also important to be aware of the importance of securitization to smaller businesses that seek real estate financing. The average CMBS securitized loan is $8 million. As of July 2010, there were more than 40,000 CMBS loans less than $10 million in size that had a combined outstanding balance of $158 billion, which makes CMBS a significant source of capital for lending to small businesses.[12] Therefore, when evaluating securitization reforms like the proposed risk retention

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[9] *See* "A Guide to Global Structured Finance Regulatory Initiatives and their Potential Impact," Fitch Ratings (Apr. 4, 2011), at 1 ("the environment for issuers and investors remains uncertain given the number of rules, the risk of them being inconsistently applied given the scope for differing interpretations, plus the varying timelines for their implementation. This market uncertainty is likely to play a part in delaying a more meaningful revival of the [structured finance] market until these issues are resolved, i.e. until mid-2012.") (available at http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=571646).

[10] *See* n. 1, *supra*..

[11] International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls," Chapter 2, *Global Financial Stability Report: Navigating the Financial Challenges Ahead* (October 2009), at 33 ("Conclusions and Policy Recommendations" section) (available at http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf).

[12] *See* Testimony of the Commercial Real Estate Finance Council before the House Financial Services Committee, Hearing on "Alternatives For Promoting Liquidity in the Commercial Real Estate Markets, Supporting Small Businesses And Increasing Job Growth" (July 29, 2010), at 3 (available at http://financialservices.house.gov/Media/file/hearings/111/CREFC%20Testimony%207.29.2010.pdf).

rules, policymakers should be mindful that changes that could halt or severely restrict securitization of CRE loans will have a disparate adverse impact on small businesses, and on capital and liquidity in CRE markets in smaller cities where smaller CRE loans are more likely to be originated.

### 3. Unique Characteristics of the CRE Market and the Need to Customize Reforms

Throughout the debate regarding securitization reform, the CRE Finance Council urged that the reforms be tailored to account for the differences that exist among the various types of asset classes (e.g. residential mortgages, commercial mortgages, student loans, auto loans, etc.), because customization helps ensure that measures designed to strengthen the financial markets and foster investor confidence do not inadvertently create negative implications for capital, liquidity and credit availability.

Using our industry as an example, CMBS has innate characteristics that minimize the risky securitization practices that policymakers sought to address in Dodd-Frank. More specifically, the unique characteristics that set CMBS apart from other types of assets relate not only to the type and sophistication of the borrowers, but to the structure of securities, the underlying collateral, and the existing level of transparency in CMBS deals, each of which are briefly described here:

- **Commercial Borrowers**: Part of the difficulty for securitization as an industry arose from practices in the residential sector where, for example, loans were underwritten in the subprime category for borrowers who may not have been able to document their income, or who may not have understood the effects of factors like floating interest rates and balloon payments on their mortgage's affordability. In contrast, commercial borrowers are highly sophisticated businesses with cash flows based on business operations and/or tenants under leases (i.e. "income-producing" properties). Additionally, securitized commercial mortgages have different terms (generally 5-10 year "balloon" loans), and they are, in the vast majority of cases, "non-recourse" loans that allow the lender to seize the collateral in the event of default.

- **Structure of CMBS**: There are multiple levels of review and diligence concerning the collateral underlying CMBS, which help ensure that investors have a well informed, thorough understanding of the risks involved. Specifically, in-depth property-level disclosure and review are done by credit rating agencies as part of the process of rating CMBS bonds. Moreover, non-statistical analysis is performed on CMBS pools. This review is possible given that there are far fewer commercial loans in a pool (traditionally, between 100-200 loans; while some recent issuances have had between 30 and 40 loans) that support a bond, as opposed, for example, to residential pools, which are typically comprised of between 1,000 and 4,000 loans. The more limited number of loans (and the tangible nature of properties) in the commercial context allows market participants (investors, rating agencies, etc.) to gather detailed information about income-producing properties and the integrity of their cash flows, the credit quality of tenants, and the experience and integrity of the borrower and its sponsors, and thus conduct independent and extensive due diligence on the underlying collateral supporting their CMBS investments.

- **First-Loss Investor ("B-Piece Buyer") Re-Underwrites Risk**: CMBS bond issuances typically include a first-loss, non-investment grade bond component. The

third-party investors that purchase these lowest-rated securities (referred to as "B-piece" or "first-loss" investors) conduct their own extensive due diligence (usually including, for example, site visits to every property that collateralizes a loan in the loan pool) and essentially re-underwrite all of the loans in the proposed pool. Because of this, the B-piece buyers often negotiate the removal of any loans they consider to be unsatisfactory from a credit perspective, and specifically negotiate with bond sponsors or originators to purchase this non-investment-grade risk component of the bond offering. This third-party investor due diligence and negotiation occurs on every deal before the investment-grade bonds are issued. We also note that certain types of securitized structures are written so conservatively that they do not include a traditional "B-Piece." Such structures, for example, include extremely low loan-to-value, high debt-service-coverage-ratio pools that are tranched only to investment grade.

- **Greater Transparency**: CMBS market participants already have access to a wealth of information through the CRE Finance Council Investor Reporting Package™, which provides access to loan-, property-, and bond-level information at issuance and while securities are outstanding, including updated bond balances, amount of interest and principal received, and bond ratings. Our reporting package has been so successful in the commercial space that it is now serving as a model for the residential mortgage-backed securities market. By way of contrast, in the residential realm, transparency and disclosure are limited not only by servicers, but by privacy laws that limit access to borrowers' identifying information. Importantly, the CRE Finance Council released version "5.1" of the IRP in December 2010 to make even further improvements. The updated IRP was responsive to investor needs, including disclosures for a new "Loan Modification Template." Also, as referenced above and as discussed in greater detail in Part 5 below, CRE Finance Council working groups – comprised of all CMBS constituencies (issuers, investors, etc.) – have created standard practices that could be used immediately in the market to enhance disclosure, improve underwriting, and strengthen representations and warranties to ensure alignment of interests between issuers and investors. These consensus standards build on existing safeguards in CMBS and go beyond Dodd-Frank requirements for CRE loans.

As policymakers are aware, Congress specifically concluded in Dodd-Frank's risk retention provision[13] that with respect to commercial mortgages and CMBS, "skin-in-the game" measures or the "alignment of risk" could take a number of permissible forms, including potential retention by a securitizer or originator. Recognizing the role that B-piece investors have traditionally played in the CMBS market, the statute also contemplated potential risk retention by a third-party investor who performs due diligence and retains this risk in accordance with the statute. The CRE Finance Council's membership is united in the view that the alignment of the interests of lenders, issuers and investors in the securitization process is essential.

The CRE Finance Council appreciates that regulators have sought to develop risk retention regulations that are tailored to the unique characteristics of the CRE finance market and to offer some

[13] Dodd-Frank, § 941(b) (adding Securities Exchange Act § 15G (c)).

flexibility in certain respects. We are now engaged in the task of analyzing the proposed risk retention regulations, and assessing their impact and practicality.

**4. Preliminary Views on the Proposed Risk Retention Rule**

The proposed risk retention rule was first released on March 29, 2011, by the FDIC. As mentioned, the proposal is complex, and it will accordingly take several weeks for the industry to digest and to understand the potential ramifications of the rule. At this point, our preliminary view is that the structural framework of the CMBS-specific provisions could provide a workable foundation for implementing the risk retention rules as Congress envisioned in Dodd-Frank. However, there are areas where the rule could have unintended adverse consequences for securitization and the broader CRE finance market. At the same time, the purpose of many important provisions is unclear, and they will likely need to be refined to ensure that they accomplish their intent in the least disruptive manner. Needless to say, the stakes are high with the impact on credit availability weighing in the balance, and we look forward to working with Congress and the regulators to ensure a regulatory framework that supports a sound and vibrant securitization market, which is critical to consumers in the U.S. economy.

*The Proposed Risk Retention Regulation for Commercial Mortgages*

By way of background, the proposed risk retention regulation contains "base" risk retention requirements that generally apply to all asset classes. The base requirements include a number of options for the securitizer to hold the required 5% retained interest, such as: a "vertical slice," which involves holding 5% of each class of ABS interests issued in the securitization; a horizontal residual interest, which requires that the securitizer retain a first-loss exposure equal to at least 5% of the par value of all the ABS interests issued in the transaction; and an "L-shaped" option which involves a combination of the vertical and horizontal options. The CRE Finance Council believes generally that the menu of options for holding the retained interest will be beneficial in that this flexibility will foster more efficient and practical structuring of securitizations than a one-size-fits-all approach, and we commend regulators for the thought and effort they put into developing these options.

The retained risk would be required to be held for the life of the securitization. No sale or transfer of the retained interest would be permitted, except in limited circumstances.

Notably, the base retention regime includes a restriction on the ability of securitizers to monetize excess spread on underlying assets at the inception of the securitization transaction, such as through sale of premium or interest-only ("IO") tranches. As discussed below in greater detail, this provision, which requires securitizers to establish a "premium capture cash reserve account" where a transaction is structured to monetize excess spread, and to hold this account in a first-loss position even ahead of the retained interest, has generated considerable confusion throughout the market, and the purpose of the provision is unclear. It should be noted that this particular provision is one that is prompting significant concerns about a potential adverse impact on the viability of the CMBS market, as well as questions about whether it can be implemented as a practical matter without shutting down the market for new CMBS issuance.

Hedging of the retained interest is generally prohibited, although the proposed regulation gives securitizers the ability to use tools, such as foreign currency risk hedges, that do not directly involve hedging against the specific credit risk associated with the retained interest. The continued ability to use market risk hedges is a matter the ABS issuer community viewed as critical to the viability of

securitization, and we believe that the proposed rule is generally responsive to the market's concerns in that regard.

In addition to the base risk retention rules, there are two important provisions specific to commercial mortgages. First, there is an option to have a third-party purchaser hold a 5% horizontal first-loss position. The third-party retention option is subject to several conditions, which are being closely examined, but market participants have noted a lack of clarity with respect to some of the conditions, and there are concerns that some of the conditions may create significant disincentives for use of this retention option. An unworkable third-party retention option would render the rule more inflexible, which may run counter to the intent of Congress when it outlined third-party risk retention as one of the options for the CRE market in Dodd-Frank.

Second, there is a commercial mortgage loan exemption that would subject qualified commercial mortgage loans to a 0% retention obligation, if several criteria are met. While we understand that regulators intended that only a small subset of "low-risk" loans would qualify for the exemption, our initial examination of the CRE exemption provision reflects that the parameters for qualified commercial mortgages are so narrow that virtually no CRE mortgage could qualify. This stands in contrast to other asset classes, where we understand that proposed exemptions could cover an appreciably larger percentage of the universe of loans.

Three components of the proposed rules have generated the most internal discussion and debate among the CRE Finance Council's members.

*Premium Capture Cash Reserve Accounts.* First, there is considerable confusion and concern within the CRE finance community about the proposed rule's requirement that securitizers establish a "premium capture cash reserve account" when a transaction is structured to monetize excess spread at the inception of the securitization transaction, such as through an IO tranche. One issue is that the purpose of such a requirement is unclear. The narrative to the proposed rule states that the purpose of the premium capture is to prevent sponsors of the securitization from "reduc[ing] the impact of any economic interest they may have retained in the outcome of the transaction and in the credit quality of the assets they securitized,"[14] presumably by extracting all of their profit on the deal at the outset. However, the CRE Finance Council is informed through preliminary discussions with the regulatory agencies, for example, that the premium capture feature was designed to ensure that the retained interest, whether held by the sponsor or a third party, represents 5% of the transaction proceeds.

The effect of the proposal as drafted would be for all revenue from excess spread (which is virtually all revenue) to be retained for the life of the transaction. Such a mechanism will inhibit an issuer's ability to pay operating expenses, transaction expenses, and realize profits from the securitization until, typically, ten years from the date of a securitization. Thus, while the proposed rule's narrative expressed regulators' expectation that the premium capture feature would merely prompt securitization sponsors to stop structuring securitizations to monetize excess spread at closing,[15] the broader impact would be to make the securitization business very unattractive to sponsors, which in turn, would shrink capital availability. For this reason, many in our industry have significant concerns about the premium capture component having an adverse impact on the viability of the CMBS market.

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[14] Risk Retention NPRM at 89.

[15] *See id.* at 90.

*Conditions for Retention by a Third-Party Purchaser*. Second, the third-party retention option that was specifically designed for CMBS also has generated substantial discussion. Under the proposal, the option is subject to several conditions.[16] Most notable among the conditions is a requirement that an independent Operating Advisor be appointed where a third-party purchaser retains the risk and also has control rights (itself or through an affiliate) that are not collectively shared with all other classes of bondholders, such as servicing or special servicing rights.[17] The Operating Advisor would have to be consulted on all major servicing decisions, such as loan modifications or foreclosures, and would have the ability to recommend replacement of the servicer or special servicer if it determines that the servicer or special servicer is not acting in the best interests of the investors as a whole. Only a majority vote of each class of bondholder would prevent the servicer or special servicer from being replaced in this instance.

As a preliminary matter, certain aspects of the Operating Advisor provision are not sufficiently fleshed out, and our membership believes that additional clarity will be necessary for an Operating Advisor framework to function efficiently. For example, other than requiring the Operating Advisor to be independent, the proposed rule provides no specifics on qualifications for an entity to serve as an Operating Advisor, such as whether the entity should have expertise in dealing with the class of securities that are the subject of the securitization. CMBS servicing can be a complex and highly fact-specific enterprise and CMBS transaction parties, including B-piece buyers who might hold the retained interest under the proposed rule and who may handle servicing or special servicing, are sophisticated and very experienced in these matters. It is unlikely that such a B-piece buyer would accept the appointment of an Operating Advisor lacking in CMBS expertise to oversee servicing. Nor should this be a desirable from regulators' perspective, since an unqualified Operating Advisor is unlikely to add value, and would only add to transaction costs.

B-piece buyers and issuers also have raised concerns that the Operating Advisor requirement may create other significant disincentives for use of the third party retention option. For example, some question whether it is necessary for an Operating Advisor to have the authority to oversee servicing and have replacement rights from the deal's inception, when a B-piece buyer's capital is at risk in a first-loss position, which gives a B-piece/servicer incentives that are more fully aligned with those of other investors. Moreover, there are concerns that the addition of another administrative layer in the securitization process may make the servicing and workout of securitized loans more difficult from the borrower's perspective.

Some investment-grade investors have expressed interest in the Operating Advisor construct, but at a minimum, there clearly is room to better hone the powers of and the limitations on the requisite Operating Advisor. For example, one suggestion being discussed to address concerns of B-piece buyers and investment-grade investors is to have the Operating Advisors' recommendations to replace servicers approved by a majority vote of investors, rather than requiring a majority to disapprove as the proposed rule currently contemplates.[18]

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[16] *See id.* at 75-81.

[17] *Id.* at 77-79.

[18] *See id.* at 79.

We note that there is precedent in the market for use of independent Operating Advisors in these circumstances, as the industry has developed a fairly standard Operating Advisor framework with input from B-piece buyers, investors, and issuers in the past few years. In this regard, one matter being discussed within the industry is identifying the most practical analogue to examine among past transactions, and whether the best analogue would be deals that only involved an independent Operating Advisor once the B-piece buyer/servicer is "out of the money" and its interests theoretically would not perfectly align with those of other bondholders. Such a structure might solve the alignment of interest concern while also addressing B-piece buyers' understandable reluctance to have servicing decisions second-guessed by a third-party when the B-piece buyer's investment is first in line should there be losses.

*Exempt Commercial Mortgages.* There is a commercial mortgage loan exemption that would subject "qualified" commercial mortgage loan pools to a 0% retention obligation, if several criteria are met. Regulators have stated that they only intended for a relatively small percentage of loans, meeting a set of "low-risk" characteristics, to qualify for the exemption. While the CRE Finance Council understands this objective, our initial examination of the CRE exemption provision reflects that the parameters for qualified commercial mortgages are so narrow that virtually no CMBS mortgages could qualify.

The exemption's 20-year maximum amortization requirement,[19] for instance, presents perhaps the most significant hurdle to qualification, since commercial mortgages are amortized on a 30-year basis. One issue the CRE Finance Council's members are discussing is identifying a better metric for assessing the risk characteristics of a loan such as the loan-to-value ratio at origination and maturity. Also problematic is the requirement that borrowers covenant not to use the property as collateral for any other indebtedness, which appears to effectively prohibit subordinate debt.[20] Currently, borrowers typically are permitted to have subordinate debt upon lender approval (e.g., loans that have subordinate debt funded concurrent with the first mortgage). It follows that an outright prohibition on subordinate debt, regardless of lender approval, may be viewed by borrowers as an undue restriction of their ability to manage their finances.

That said, as part of its market standards initiative, the CRE Finance Council submitted an underwriting principles framework white paper to the regulators during the rule-making process highlighting the difficulty in creating universally objective metrics that would indicate that a loan is "low risk" in the very heterogeneous commercial mortgage space. Given the proposed rule, however, we are taking a fresh look at these issues and attempting to evaluate whether the "qualified CRE loan" construct could be re-worked to be of value for CRE loans. There are loan segments outside of the typical conduit loan structure – like large loan and single-borrower securitization deals – that may be more suited for the exemption treatment and we are evaluating what the appropriate "low risk" metrics should be for such deals.

Additionally, a fourth area of concern about the proposed rule that should be highlighted relates to the duration of retention, and a prohibition on sale or transfer of retained interest. As mentioned, the proposed rule contemplates holding the retained interest for the life of the bond, and imposes a

[19] *See id.* at 306.

[20] *See id.* at 304.

permanent prohibition on the sale or transfer of retained risk.[21] Both of these features would restrict the flow of capital into the markets for an unnecessarily long time period, a situation that is even less desirable in light of the $1 trillion in commercial mortgage maturities that will occur in the next few years, at the same time the CMBS market is struggling to recover. We also note that in the third-party retention context, a permanent prohibition on the sale or transfer of retained risk would not be acceptable to many B-piece buyers.

Our members are evaluating the extent to which the proper alignment of risk can be achieved without making the mandated retention permanent. We also believe that it is not necessary to completely restrict any sale or transfer of retained interest to achieve the risk retention regulation's goals. The CRE Finance Council's members are discussing, for example, whether these concerns could be addressed by allowing transfer of a B-piece buyer's or sponsor's retained interest to a "qualified" transferee, who would have to comply with the obligations imposed on the transferor and meet other criteria.

On all of these issues, as well as for the more technical issues that will emerge during the course of our evaluation, the CRE Finance Council intends to work with regulators on modifications that will facilitate proper alignment of risk without unduly restricting market capital and liquidity.

**5. The CRE Finance Industry's Market Standards**

While policymakers have been working on crafting risk retention regulations with a view toward strengthening the securitization markets and fostering investor confidence, the CRE finance industry has not been idle. Rather, our members across all constituencies have devoted an extraordinary amount of time over the past year to working collaboratively and diligently on the development of market standards in the areas of representations and warranties; underwriting principles; and initial disclosures, all of which have similar aims of strengthening our market and fostering investor confidence.

We anticipate that the new industry market standards, coupled with the ongoing disclosure regime offered by our existing IRP, will create increased transparency and disclosure in underwriting and improved industry representations and warranties, which we believe will go a long way toward meeting both investor demands and Dodd-Frank objectives. Having previously have shared these projects with the regulators charged with implementing the Dodd-Frank risk retention rules, the CRE Finance Council wishes to provide some information to Congress as well about the projects.

The CRE Finance Council uses task forces and committees comprised of persons representing all constituencies to form consensus views for industry standards and best practices. These initiatives are both responsive to investor requests and reflect broad input from issuer representatives. And they are welcome standards that we expect to be widely used in the commercial real estate finance marketplace in the same vein as our IRP™ for ongoing disclosures.

*Representations and Warranties*

Building upon existing customary representations and warranties for CMBS, the CRE Finance Council has created Model Representations and Warranties that represent industry consensus

[21] *See id.* at 100.

viewpoints. Representations and warranties relate to assertions that lenders make about loan qualities, characteristics, and the lender's due diligence. The CRE Finance Council's model was the result of 200-plus hours of work by our Representations and Warranties Committee over the last six months, and represents the input of more than 50 market participants during negotiations to achieve industry consensus.

The Model Representations and Warranties were specifically crafted to meet the needs of CMBS investors in a way that is also acceptable to issuers. Such Model Representations and Warranties for CMBS will be made by the loan seller in the mortgage loan purchase agreement. Issuers are free to provide the representations and warranties of their choosing, and the representations and warranties will necessarily differ from one deal to another because representations and warranties are fact based. However, issuers will be required to present all prospective bond investors with a comparison via black line of the actual representations and warranties they make to the newly created the CRE Finance Council Model Representations and Warranties. Additionally, loan-by-loan exceptions to the representations and warranties must also be disclosed to all prospective bond investors.

Finally, the CRE Finance Council also has developed market standards for addressing and resolving breach claims in an expedited, reliable and fair fashion by way of mandatory mediation before any lawsuit can be commenced, thereby streamlining resolution and avoiding unnecessary costs.

For many investors, strengthened and new representations and warranties coupled with extensive disclosure are considered a form of risk retention that is much more valuable than having an issuer hold a 5% vertical or horizontal strip. The CRE Finance Council believes that its Model Representations and Warranties are a practical and workable point of reference that has already been vetted by the industry, and we intend to explore whether industry standard representations and warranties such as the CRE Finance Council's model could be adopted by regulators to serve as "adequate" representations and warranties as contemplated by the Dodd-Frank menu of options for risk retention for commercial mortgages.

Moreover, industry-standard representations and warranties could be used in at least two other regulatory contexts. First, the conditions on third-party retention in the proposed regulation contemplate securitizer disclosures regarding representations and warranties, and the possible use of blacklines against industry standard representations and warranties. We are exploring the possibility of suggesting use of the CRE Finance Council's model for this purpose.

In addition, Dodd-Frank Section 943(1) directs the SEC to develop regulations requiring credit rating agencies (CRAs) to include in ratings reports a description of the representations, warranties, and enforcement mechanisms available to investors for the issuance in question, along with a description of how those representations, warranties and enforcement mechanisms differ from those in "issuances of similar securities." CRAs have played an important role in the CRE Finance Council's development of Model Representations and Warranties, and we believe the Model Representations and Warranties can facilitate CRAs' fulfillment of their new reporting requirements under Dodd-Frank Section 943(1).

*Loan Underwriting Principles*

Commercial mortgages securitized through CMBS do not easily lend themselves to the development of universally applicable objective criteria that would be indicative of having lower credit risk as envisioned under Dodd-Frank or otherwise. This is because these non-recourse loans are

collateralized by income streams from an incredibly diverse array of commercial property types that cannot be meaningfully categorized in a way that would allow for the practical application of such objective "low credit risk" criteria. For example, it is difficult to meaningfully compare property types such as hotels, malls, and office buildings, and credit risk profiles can also vary by geographic location, so that it would be even more difficult to compare a resort in Hawaii to a shopping mall in Texas or an office building in New York. In short, commercial properties are not homogeneous and do not lend themselves to a "one size fits all" underwriting standard that could be deemed "adequate."

The industry accordingly created a framework of principles and procedures that are characteristic of a comprehensive underwriting process that enables lenders to mitigate the risk of default associated with all loans, and a disclosure regime that requires representations as to the manner in which that underwriting process was performed. The intent of the CRE Finance Council's Underwriting Principles is to be responsive to investors and market participants; provide for the characteristics of low-risk loans; and provide for common definitions and computations for the key metrics used by lenders.

Our membership believes that this principles-based underwriting framework can and will generate the underwriting of lower credit risk CMBS loans and, when combined with necessary and appropriate underwriting transparency, will allow investors to make their own independent underwriting evaluation and be in a position to better evaluate the risk profiles of the loans included in the CMBS issuances in which they are considering investing. It is also critical to note that the majority of the underwriting principles and disclosures outlined in our Underwriting Principles are already standard industry practices, though they had not previously been formally outlined or presented.

The Underwriting Principles were developed with a view toward reducing risk through use of market analysis; property and cash flow analysis; borrower analysis; loan structure and credit enhancements; risk factors such as macro and property-type risks. With respect to defining numerical underwriting metrics, our project recognized the impossibility of imposing uniform metrics since the characteristics of a "low risk" CRE loan could vary by property type, area of the country, and even by operator, and low risk loan-to-value ratios differ by geographic area.

While we have long maintained that it is not possible or even advisable for regulators to attempt to define uniform underwriting "standards" for CRE loans due to the heterogeneous nature of commercial mortgages underlying CMBS and the dissimilarity of this market to residential, we recognize that regulators have attempted to do just that in the qualified commercial loan provisions of the proposed risk retention regulations. We wish to point out, in any event, that such criteria exclude many low-risk loans from qualifying for the exemption, and should not be viewed as the sole framework for assessing whether a commercial mortgage is low risk.

*"Annex A" Initial Disclosures*

The CRE Finance Council's "Annex A" has long been a part of the package of materials given to investors as part of CMBS offering materials, and provides detailed information on the securitized mortgage loans. In conjunction with the SEC's Spring 2010 proposal to revise its Regulation AB, our members commenced an initiative to review, update and standardize Annex A, which has resulted in changes to Annex A incorporating numerous additional data points concerning the assets underlying CMBS. This work was the effort of both issuers and investors.

These changes, together with the information already required by Annex A, closely conform Annex A with the Schedule L asset-level disclosure framework proposed by the Commission under Regulation AB. The CRE Finance Council's newly created standardized Annex A provides numerous additional data points concerning the assets underlying CMBS, including, but not limited to:

- Changes to the Loan Structure Section with regard to Disclosures on supplemental debt. Examples include, but are not limited to, detail of all rake, B-note, subordinated mortgage, mezzanine debt and preferred equity as well as information regarding the debt owner, coupon, loan type, term, amortization, debt service calculation, debt yield, cumulative debt service coverage ratio and loan-to-value calculations through the capital structure.

- Additionally, issuers will now be providing a breakdown of net operating income into revenue and expenses for historic and underwriting basis.

- Added information on the fourth and fifth largest tenants at a property to the tenant information section – most Annex As in the past would contain information on the three largest tenants at a property, that information being square footage leased, % of overall net rentable square feet, and lease expiration date.

In fact, Annex A provides more information than required under Schedule L and is available to market participants in more expedited fashion. At the same time, the new standardized Annex A is consistent with the existing practices that CMBS market issuers and other participants have developed to provide CMBS investors with clear, timely and useful disclosure and reporting that is specifically tailored for CMBS investors. We believe that such consistency will avoid unnecessary increases in transaction costs while still delivering enhanced clarity and transparency.

It follows that the CRE Finance Council's Annex A is a practical and workable framework that has already been vetted by the industry, and we believe it can be adopted by the SEC to implement the asset-level and loan-level disclosure requirements in Dodd-Frank Section 942(b), and those in Proposed Schedule L to SEC Regulation AB.

**Conclusion**

Today, the CMBS market is showing some positive signs that it is slowly moving toward recovery, but with $1 trillion in commercial mortgage loans maturing in the next few years, it will be critically important that risk retention regulations be implemented in way that does not severely constrict or shut down the securitization markets. The CRE Finance Council appreciates the fact that the general construct of the proposed risk retention rule attempts to customize and provide options for the commercial mortgage asset class. At the same time, our members strongly believe that the proposal needs clarification in many areas. And we also have concerns about the impact of some of the details, including concerns that these aspects could make securitization an untenable prospect for issuers and third-party investors.

The CRE Finance Council believes these concerns can, and should, be addressed in the rulemaking process, and we anticipate working with regulators on clarifications and refinements that can achieve an appropriate alignment of risk while also avoiding undue restriction of capital and liquidity in the CRE finance market.

March 25, 2010

The Honorable Christopher J. Dodd
Chairman
U.S. Senate Committee on Banking,
Housing & Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20515

The Honorable Richard C. Shelby
Ranking Member
U.S. Senate Committee on Banking,
Housing & Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20515

Dear Chairman Dodd and Ranking Member Shelby:

The undersigned groups represent a broad segment of the U.S. economy that provide or use credit, including builders, developers and other borrowers of all types, lenders of all sizes, investors at all levels, and other service providers, among many others. It is from each of our unique perspectives that we view financial regulatory reform and have an interest in ensuring strong and vibrant credit markets that will support an economic recovery.

As you know, the $9 trillion structured finance markets are critical to supporting lending and overall credit availability for millions of Americans, from consumers looking to purchase or refinance a home, receive a student loan, or buy a car, to businesses that need capital to create jobs and fuel economic growth. The securitized credit markets have helped provide liquidity using private investors – such as pension funds, mutual funds, and endowments, among others – who bring their own capital to the table to fuel lending, contributing to approximately 40% of the credit in the United States over the last 15 years. Given the importance of these markets, we wboleheartedly agree with Treasury Secretary Geithner's statement that, "[b]ecause this vital source of lending has frozen up, no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small."

Today, the securitized credit markets (which include residential and commercial mortgage loans, student loans, auto loans, credit card, small business, and corporate loans, among others) face a multitude of challenges that, when taken together, will undoubtedly impact the capital and liquidity needed to support credit availability:

- First, credit capacity remains constrained despite enormous borrower demand and significant loan maturities (e.g., $1 trillion in commercial mortgage loans alone in the next few years), while asset values continue to decline (i.e. there is an "equity gap" between loan amount and asset value) and the overall recession has affected job growth and business performance. This combination of difficulties is most keenly affecting the commercial and residential mortgage sectors.

- Second, at the same time that the securitized credit markets are a centerpiece of recovery efforts, new and retroactive accounting changes (known as FAS 166 and 167) have been finalized, and combined with new regulatory capital guidelines, will limit balance sheet capacity and the overall amount of capital that can be directed toward such lending and investing. These changes are now being implemented during an extraordinarily challenging time.

- Third, there are new proposals – known as "risk retention" – that would require loan "originators" and/or "securitizers" to retain a percentage (e.g. 5 percent) of every loan made or bond issued, which over time limits balance sheet and lending capacity. Of even greater concern, under the new accounting rules above, financial institutions could be required to account for 100 percent of the assets on balance sheet, and to hold additional capital based on such requirements, despite no material change in real credit risk beyond the retained piece.

The combined impact of these items creates tremendous uncertainty and impacts credit availability, which has a profound effect on our overall economic recovery. In fact, while there is growing recognition among market participants and financial regulators about the complications of such reform mandates, it still remains unclear what the combined impact will be in the short and long term, and this uncertainty today serves as one of the biggest impediments to new private lending and investing. Put simply, given the totality and far reaching implications of regulatory and accounting changes, there are serious concerns about the future viability of the securitization markets that are critical to borrower access to credit and an overall recovery.

In this regard, we are not alone in expressing such caution. Federal Reserve Board Member Elizabeth Duke, for example, observed that "[i]f the risk retention requirements, combined with accounting standards governing the treatment of off-balance-sheet entities, make it impossible for firms to reduce the balance sheet through securitization and if, at the same time, leverage ratios limit balance sheet growth, we could be faced with substantially less credit availability… As policymakers and others work to create a new framework for securitization, we need to be mindful of falling into the trap of letting either the accounting or regulatory capital drive us to the wrong model." Likewise, Comptroller of the Currency John C. Dugan recently echoed this concern: "[i]f we do not appropriately calibrate and coordinate our actions, rather than reviving a healthy securitization market, we risk perpetuating its decline – with significant and long-lasting effects on credit availability."

Accordingly, it is absolutely crucial that any reforms aimed at the securitized credit markets, such as a risk retention mandate, be examined in greater detail and in the context of other changes in order to strengthen these markets and better serve consumers and businesses. Such a review must consider how to accomplish public policy goals, while limiting adverse or unintended consequences. It should also take into account the differences in markets and types of financial products to ensure that reforms are customized and that financial regulators have explicit direction on the potential application of statutory changes in the various and inherently different asset classes. This approach has been recommended by the International Monetary Fund (IMF), which concluded that "policies designed to put more securitizer skin in the game also risk closing down parts of securitization markets if poorly designed and implemented… Before implementing such schemes, authorities should conduct impact studies to ensure that they fully understand the potential effects of all the regulations in their totality."

Therefore, as you seek to build a more robust financial system with improved transparency and important safeguards, we urge you to consider carefully the entirety of the reforms being contemplated in an effort to ensure that all reforms are coordinated and implemented in a way that fully supports their intended objectives. It is of vital importance that any new legislative, regulatory or accounting changes provide certainty and confidence, and that they support, and not impede, a recovery in the securitized credit markets that fuel our overall economy.

We appreciate your efforts to address challenging issues that are critical to restoring the flow of credit for consumers and businesses. We stand ready to work with you to achieve these goals.

Sincerely,

American Bankers Association
American Hotel & Lodging Association
American Resort Development Association
American Securitization Forum
Associated General Contractors of America
Building Owners and Managers Association International
Certified Commercial Investment Member Institute (CCIM Institute)
Commercial Real Estate Finance Council (formerly CMSA)
Community Mortgage Banking Project
The Financial Services Roundtable
Housing Policy Council
Institute of Real Estate Management
International Council of Shopping Centers
Loan Syndications and Trading Association
Mortgage Bankers Association
NAIOP, Commercial Real Estate Development Association
National Apartment Association
National Association of Real Estate Investment Trusts
National Association of Real Estate Investment Managers
National Association of Home Builders
National Multi Housing Council
The Real Estate Roundtable
Securities Industry and Financial Markets Association

cc: Members of the Senate Committee on Banking, Housing and Urban Affairs

**EMBARGOED UNTIL DELIVERY**

**STATEMENT OF**

**MICHAEL H. KRIMMINGER**
**GENERAL COUNSEL**
**FEDERAL DEPOSIT INSURANCE CORPORATION**

**on**

# UNDERSTANDING THE IMPLICATIONS AND CONSEQUENCES OF THE PROPOSED RULE ON RISK RETENTION

**SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES**
**COMMITTEE ON FINANCIAL SERVICES**

**U.S. HOUSE OF REPRESENTATIVES**

**April 14, 2011**
**Rayburn House Office Building**
**Washington, D.C.**

Chairman Garrett, Ranking Member Waters and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation on the proposed interagency rulemaking to implement the risk retention requirements of section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The FDIC and our colleagues at the other agencies recognize that the comments and feedback from Congress and the public are vital to helping us balance competing considerations and complete final rules that achieve the statutory requirements in the most efficient way possible.

The recent financial crisis exposed shortcomings in our regulatory framework for monitoring risk and supervising the financial system. Insufficient capital at many financial institutions, combined with misaligned incentives in securitization markets and the rise of a large unregulated shadow banking system, permitted excess and instability to build up in the U.S. financial system. These conditions led directly to the liquidity crisis of September 2008 that froze our financial system and contributed to the most severe economic downturn since the Great Depression. Today, levels of foreclosures remain high, the secondary mortgage markets remain dependent on government programs, and the private residential mortgage securitization markets remain largely frozen. Serious weaknesses identified with mortgage servicing and the foreclosure process have introduced further uncertainty into an already fragile market.

Background

The private securitization market, which created more than $1 trillion in mortgage credit annually in its peak years of 2005 and 2006, has virtually ceased to exist in the wake of the financial crisis. Issuance in 2009 and 2010 was just 5 percent of peak levels. There is no question that we must have an improved model for securitization based on sound underwriting and effective alignment of incentives that will support sustainable lending and a stable securitization market. Without this framework, we will repeat the same mistakes that resulted in disastrous consequences to our economy and caused the 5.3 million borrowers that entered the foreclosure process in 2009 and 2010 to be at risk of losing their homes.

Misaligned economic incentives within mortgage securitization transactions and the widespread use of such securitizations to fund residential lending combined to play a key role in driving the precipitous decline in the housing market and the financial crisis. Almost 90 percent of subprime and Alt-A originations in the peak years of 2005 and 2006 were privately securitized. During this period, the originators and securitizers seldom retained "skin in the game." These market participants received immediate profits with each deal while secure in the knowledge that they faced little or no risk of loss if the loans defaulted. As a result, securitizers had very little incentive to maintain adequate lending and servicing standards. The substantial and immediate profits available through securitization skewed the incentives toward increased volume, rather than well underwritten, sustainable lending. As underwriting standards continued to decline in order to facilitate an increased volume of loans for securitization transactions,

increased numbers of borrowers received loans that they simply could not repay. This "originate-to-distribute" model of mortgage finance led to increasing levels of unsound loans being originated and escalating housing prices that in turn fueled the housing bubble. When housing prices reached unsustainable levels and began to decline, the house of cards collapsed and revealed the inherent flaws in the incentives of the prior securitization model.

The mortgage servicing documentation problems that were uncovered last year are yet another example of the implications of lax underwriting standards and misaligned incentives in the mortgage origination, securitization and servicing industries. In particular, the traditional, fixed level of compensation for loan servicing proved wholly inadequate to implement appropriate policies and procedures to effectively deal with the volume of problem mortgage loans. Inadequate resources led mortgage servicers to cut corners in all aspects of mortgage servicing and documentation.

The mortgage underwriting and servicing practices that contributed to the crisis need to be significantly strengthened and the economic incentives of market participants must be realigned. Thus far, this "strengthening" has largely been accomplished through the heightened risk aversion of lenders, who have tightened underwriting standards, and through investors, who have largely shunned new private securitization issuances. Going forward, however, investors' level of risk aversion will inevitably decline in the pursuit of a higher rate of return, and there will be a need to ensure that lending standards do not revert to the risky practices that contributed to the last crisis.

Our testimony will highlight areas in the recent proposed joint Agency[1] rules implementing section 941 of the Dodd-Frank Act that are of particular importance in establishing risk retention requirements and in developing criteria for high quality mortgages not subject to the risk retention requirements.

Proposed Joint Agency Rules

Subtitle D of Title IX of the Dodd Frank Act seeks to improve the asset-backed securitization process by requiring risk retention, greater transparency, improved representations and warranties, and mandatory due diligence by issuers of the securities. The risk retention requirement of section 941 of the Dodd-Frank Act is but one part of the comprehensive framework created by Subtitle D of Title IX to address lapses in the securitization market. The disclosures mandated by sections 942 and 943 of the Dodd-Frank Act will serve to enhance the transparency of the securitization markets and will improve the quality of the assets included in securitization pools. These provisions will serve as checks and balances on asset origination practices and will enable investors to evaluate repurchase obligations, instead of being exposed to unquantifiable asset repurchase risks. Further, mandated due diligence review of assets underlying the securitization required by section 945 will go a long way toward ensuring the integrity of the asset pools that are being securitized. The proposed risk retention rules, therefore,

[1] The Agencies issuing the proposed rulemaking are the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Securities and Exchange Commission and, in the case of residential mortgage assets, the Federal Housing Finance Agency and U.S. Department of Housing and Urban Development.

should not be viewed in isolation; they should be considered an important part of a comprehensive regulatory regime designed to create increased accountability for originators and securitizers and increase the information available to investors in the securitization markets.

Section 941 mandates a joint interagency rulemaking to require securitizers to retain not less than 5 percent of the credit risk of any asset that is transferred, sold, or conveyed to a third party through the issuance of an asset-backed security and to prohibit the securitizer from directly or indirectly hedging or transferring the retained interest. Section 941 also directs the Agencies to provide an exemption from the 5 percent risk retention requirement for certain classes of assets that meet underwriting standards and product features prescribed by the Agencies.

The issues covered in section 941 of the Dodd-Frank Act are complex and have generated a robust debate, both among the Agencies tasked with the rulemaking as well as market participants, consumer groups and other interested parties. The Agencies differing responsibilities to regulate a diverse range of entities and markets positively contributed to our ability to analyze the issues and respond to the challenges posed by securitization markets in a comprehensive manner. The joint proposed rulemaking asks an extensive number of questions about these complex issues.

Our testimony addresses a few of the key issues incorporated into the proposed rules. It does not cover all of the complex issues included in the proposed rules, such as

the underwriting standards for the three other asset classes (qualifying commercial real estate, commercial and auto loans) for which the Agencies were directed to develop rules. These and other issues also are of vital importance to the reestablishment of a sustainable and vibrant securitization market that will support the credit needs of our complex economy. We certainly look forward to comments on all of these aspects of the proposed rules in order to ensure that the final rules achieve the goals set by the statute.

*Five Percent Risk Retention*

As required by section 941, the proposed joint Agency rules require securitizers of asset-backed securities to retain not less than 5 percent of the credit risk of the securitized assets in most transactions. The proposed rules ensure that securitizers retain "skin in the game" and align securitizer interests with those of the securitization investors. The proposed rules will encourage better underwriting by assuring that securitizers cannot escape the consequences of their own lending practices. Fundamentally, the requirements are about reforming the "originate-to-distribute" model for securitization, and realigning the interests in structured finance towards long-term, sustainable lending.

Securitizers are able to pick from a number of options to achieve this 5 percent risk exposure. These options reflect existing market structures and are designed to provide a large degree of flexibility to market participants in structuring transactions, while simultaneously ensuring that securitizers are not able to off-load all of the risk in a

transaction. These options work in tandem with the premium capture reserve account to provide a total level of risk retention that is appropriate for different types of assets and structures.

*Premium Capture Reserve Account*

The premium capture reserve account is designed to realign the incentives towards quality underwriting by eliminating the ability of a securitizer, or originator, to capture immediately the full amount of the profit from securitization. In fact, even though some risk retention was a common feature of securitizations in the past, the ability to capture a large profit or gain immediately upon the sale of the senior bonds meant that the retained risk had little influence on underwriting standards and asset quality and made risk retention meaningless. Securitizers' ability to capture the full amount of profit up front was a major contributor to the incentives that increased volume at the expense of quality lending under the "originate to distribute" model.

To prevent a securitizer from reducing or negating the effects of risk retention by monetizing excess spread, the proposed joint Agency rule requires the issuer to hold the upfront profits or premium on the sale of the asset-backed securities in a premium capture reserve account. Funds deposited into the account must be used to cover losses on the underlying assets before the losses are allocated to any other securitization interest. The premium capture reserve account requirement complements risk retention by ensuring that a securitizer's interests remain aligned with the underlying performance and quality

of assets, while providing the securitizer with an opportunity for profit contingent only upon the longer-term performance of the underlying assets. The securitizer will receive the profits over time if the loans perform or, depending on the structure, after the more senior tranches have been paid off.

*Qualified Residential Mortgages*

While Congress set a standard of 5 percent risk retention, it also directed the Agencies to create an exemption for certain high quality home mortgages (Qualified Residential Mortgages or QRMs) "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default." The proposed rules seek to implement this statutory direction by setting strong underwriting and product feature requirements based upon extensive data made available principally by the Board of Governors of the Federal Reserve System and the Federal Housing Finance Agency, as well as by sources of proprietary information. The standards for QRMs in the proposed rules are designed to define only a subset of the normal mortgage market that the historical data have demonstrated to have a "lower risk of default." Historical loan performance data indicates the volume of residential mortgage loans that potentially meet the proposed QRM underwriting criteria is approximately $2.1 trillion or about 20 percent of all residential mortgage loans in the U.S. Approximately $8.5 trillion would *not* have qualified for the QRM exemption. The size of the potential non-QRM market will ensure a vibrant and liquid market for non-QRM loans.

The proposed standards for QRM loans focus on the underwriting and servicing standards that the available data indicate reduce the risk of default. Those standards include verification and documentation of income, past borrower performance, a prudent debt-to-income ratio for monthly housing expenses and total debt obligations, elimination of payment shock features, a maximum loan-to-value (LTV) ratio, a minimum down payment requirement, and other quality underwriting standards.

The Agencies' analysis of the data show, historically, that loans with the high standards chosen for QRM loans had lower rates of default. In fact, many of the underwriting standards proposed for the QRM loans precisely address the layered risks that were often ignored during the housing boom that led to increasingly higher delinquencies as housing prices declined. For example, it has been demonstrated that the combination of a high debt-to-income ratio for housing expenses and high total debt obligations leads to an increased likelihood of default.

Similarly, the Agencies' analysis of historical loan data showed a significant relationship between higher loan-to-value ratios and increased risk of default. As a result, the proposed rules set the maximum LTV at 80 percent and the minimum down payment at 20 percent for purchase transactions.

The QRM exemption is meant to be just that – an exemption from the regular rules. Under the proposed rule, not all homebuyers would have to meet the higher QRM standards to qualify for a mortgage. On the contrary, we anticipate that loans meeting the

QRM exemption will be a small slice of the market, with greater flexibility provided for loans securitized with risk retention or held in portfolio. The more stringent standards in the QRM exemption, such as debt-to-income ratios and LTV requirements, have raised concerns about continued access to affordable mortgage credit for low and moderate income borrowers. The FDIC shares these concerns and seeks to ensure that low- and moderate-income borrowers continue to have access to affordable mortgage credit. It is for this reason that the Agencies have sought to ensure that the non-QRM segment of the market will be cost effective for low- and moderate-income borrowers and be large enough to ensure a vibrant and liquid secondary market. We are seeking comment on the impact of the QRM standards on these borrowers as we work towards the final rules. In particular, we welcome comment on how and whether we can assure the unique needs of low- to moderate-income or first-time homebuyers can be met through other means such as Federal Housing Administration programs and down payment assistance programs.

The FDIC disagrees with those who suggest a borrower's interest rate will increase substantially when the cost of risk retention is passed through to the borrower. The FDIC's analysis indicates that the 5 percent risk retention requirement should result in only a nominal additional cost to non-QRM borrowers. The idea of risk retention in the securitization market is not a new concept. Our review of private mortgage securitization deals done in the early years of the last decade shows that risk retention of 3 to 5 percent or more was the norm. Risk retention will raise the cost of funding mortgage securitization only to the extent that the requirement exceeds what investors would demand on their own. To illustrate the potential impact of risk retention on a

borrower's costs, if the final rules were to require 5 percent risk retention where the market would have otherwise only demanded 3 percent, our analysis shows the cost of funding that mortgage pool would rise by only 10 basis points or 0.10 percent.

*Mortgage Servicing Standards*

Also included in the QRM standards are loan servicing requirements. Continued turmoil in the housing market caused by inadequate and poor quality servicing underscores the need to make sure that future securitization agreements provide appropriate resources and incentives to mitigate losses when loans become distressed. Servicing standards must also provide for a proper alignment of servicing incentives with the interests of investors and address conflicts of interest. The servicing standards included as part of the QRM requirements address many of the most significant servicing issues. For example, the servicing standards require that there be financial incentives for servicers to consider options other than foreclosure when those options will maximize value for investors.

The proposed standards also require servicers to act without regard to the interests of any particular tranche of investors; and to workout and disclose to investors in advance how second liens will be dealt with if the first lien needs to be restructured. We welcome comments on whether the servicing standards should be strengthened and whether the standards should apply to all private securitizations, not just QRM securitizations.

Conclusion

The Dodd-Frank Act and the proposed joint Agency rulemaking address one of the key drivers of the housing crisis: misaligned economic incentives in the private securitization market. In formulating the proposed rules, the Agencies sought to balance requiring the securitizer to keep "skin in the game" with a desire to minimize disruptions to existing market structures. We look forward to hearing from all stakeholders on the issues raised in the rulemaking and finalizing regulations that will restore investor confidence and the soundness of the securitization market. The comment period ends on June 10, 2011.

**Statement of**

**Patrick J. Lawler**
**Chief Economist**
**Federal Housing Finance Agency**

**Before the U.S. House of Representatives**

**Subcommittee on Capital Markets, Insurance, and**

**Government-Sponsored Enterprises**

**"Understanding the Implications and Consequences of the Proposed Rule on Risk Retention"**
**April 14, 2011**

**Statement of**
**Patrick J. Lawler, Chief Economist**
**Federal Housing Finance Agency**
**Before the U.S. House of Representatives**
**Subcommittee on Capital Markets, Insurance, and**
**Government-Sponsored Enterprises**
**"Understanding the Implications and Consequences of the**
**Proposed Rule on Risk Retention"**
**April 14, 2011**

Chairman Garrett, Ranking Member Waters and members of the Subcommittee, thank you for the opportunity to testify on the Federal Housing Finance Agency's (FHFA's) participation in the joint agency rulemaking for the implementation of the credit risk retention requirements for asset-backed securities in the Dodd-Frank Act.

One of the widely recognized causes of the financial crisis of 2008 was the poor quality of loans collateralizing many asset-backed securities, with subprime mortgages being the most flagrant culprits. Too often, lenders made loans that they would not have been willing to hold themselves only because they knew they could sell them to securitizers at an attractive price. Pools of such loans were used to back securities that were structured so that most of the securities received high credit ratings and were purchased by investors who gave little attention to underlying loan quality.

This "originate-to-distribute" model lacked the proper incentives for the origination and securitization of high quality loans, with fair terms for borrowers and proper underwriting to prudent standards. Risk retention better aligns the incentives between securitizers and investors and reduces information asymmetries by requiring that securitizers of asset-backed securities have a financial stake in the performance of loans underlying a security, or "skin-in-the-game." Through risk retention, including exemptions for loans with characteristics that imply a lower risk of default, securitizers will have a disincentive to acquire poor quality loans for securitization, which, in turn, will make originators less interested in making such loans. Investors, therefore, should be more willing to provide capital for residential mortgages and

other types of loans. This may be an important step in facilitating the return of private capital to the residential housing market and other lending markets that benefit from securitization.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203), enacted on July 21, 2010, requires in Section 941 that the federal banking agencies (Office of the Comptroller of the Currency, Federal Reserve, and Federal Deposit Insurance Corporation (FDIC)) and Securities and Exchange Commission (SEC) jointly prescribe regulations to require that securitizers retain a portion of the credit risk of loans that collateralize asset-backed securities. The Act included FHFA and the Department of Housing and Urban Development (HUD) among the joint rulemaking agencies for the purpose of the residential mortgage asset class and also for jointly defining and creating an exemption from the risk retention requirements for qualified residential mortgages (QRM). The Act charged the Chairman of the Financial Stability Oversight Council with the responsibility to coordinate the rulemaking.

The agencies jointly released a notice of proposed rulemaking (NPR) the last week in March 2011. The public comment period runs through June 10, 2011, after which the agencies will consider the comments and publish a final rule. The Act provides for the final regulations to become effective one year after publication for residential mortgages, and two years after publication for the other asset classes.

This proposed rule is the product of a long and deliberative process. It started well before the passage of the Dodd-Frank Act under the aegis of the President's Working Group on Financial Markets (PWG) in 2009. Over a period of several months, many of the same regulators that have proposed this rule discussed earlier proposals by the SEC and the FDIC to require or reward some degree of risk retention in securitizations.

After enactment of the Dodd-Frank Act, the Department of the Treasury began hosting meetings of the banking agencies, SEC, FHFA and HUD for the purpose of coordinating the rulemaking on risk retention. It was FHFA's goal, along with the other agencies, to develop draft rules in line with the Act's express language and its intent to align the interests of investors and securitizers and to provide for growth and stability in the securitization market in a responsible

manner. In developing the rule, the agencies sought to have a meaningful level of credit risk retention, while reducing the potential for the rule to affect negatively the availability and cost of credit to families and businesses. We also recognized that the NPR is not a final product, and we included more than 170 questions for public comment, to assist in shaping the final rule.

In today's testimony, I am going to focus on some areas that received a lot of attention by the agencies and have also been the subject of early public commentary. They include the tightness of the underwriting standards for the QRM exemption, especially the required down payment; the types of risk retention allowed, including the premium capture accounts that would be required for some securitizations and the special risk retention rules proposed for Fannie Mae and Freddie Mac (the Enterprises); and the servicing rules associated with the QRM exemption.

**Standards for Qualified Residential Mortgages**

The Act directs the agencies to define QRM, taking into consideration those underwriting and product features that historical loan performance data indicate result in a lower risk of default. These features include documentation and verification of borrower financial resources; housing- and total debt- to-income payment ratios; mitigation of payment shock on adjustable-rate mortgages; mortgage insurance to the extent that it reduces the risk of default; and restriction of high-risk features, such as negative amortization, interest-only payments, and prepayment penalties.

The agencies must require that securities consisting of one or more non-QRM loans be subject to retention of not less than five percent of the credit risk, but the Act provides latitude for the agencies to specify the permissible forms of risk retention and to allow the securitizers to allocate some or all of the risk retention to loan originators.

The proposed QRM standards were designed to reflect an understanding that Congress intended that risk retention be the norm, with only the best loans exempt. For risk retention to be successful, there needs to be a sufficient quantity of non-QRM loans of acceptable quality, so that non-QRM securities can achieve a reasonable degree of liquidity. If non-QRM loans are relatively scarce, their costs will be higher and their availability will suffer.

The main requirements for a loan to meet the proposed QRM standards are:

- Loan must be a closed-end, first-lien, owner-occupied mortgage.
- Home purchaser must make a minimum down payment of 20 percent of the purchase price plus closing costs. Subordinate financing is not allowed on purchase loans. Rate and term refinances and cash-out refinances must have combined loan-to-value ratios (LTVs) no greater than 75 percent and 70 percent, respectively.
- Borrower's mortgage debt payments cannot exceed 28 percent of income and total debt payments cannot exceed 36 percent of income.
- Loan terms cannot exceed 30 years, and interest-only, negative-amortization, balloon loans, and prepayment penalties are not eligible. Points and fees cannot exceed three percent of the loan amount, and there are payment caps on adjustable rate mortgages to mitigate payment shock.
- Borrowers must be current and cannot have missed two consecutive payments on any consumer debt in the past two years; and cannot have had a bankruptcy, foreclosure or short sale within the past three years.
- Servicing standards must incorporate loss mitigation practices and address subordinate liens.
- Mortgage insurance may not be used to meet the borrower equity requirements. While mortgage insurance reduces loss severity, the agencies did not find substantive evidence that default rates have been reduced by mortgage insurance. The rulemaking solicits public comments in this area.

In developing the standards for QRM, the agencies examined the historical performance of loans with different risk attributes. FHFA contributed to this analysis by examining the delinquency performance of loans acquired by Fannie Mae and Freddie Mac over the period from 1997 to 2009 for each of the major QRM risk factors. FHFA posted a Mortgage Market Note titled "Qualified Residential Mortgages" on its website on April 12, 2011. That document summarizes the methodology we used and provides quantitative results.[1]

[1] http://www.fhfa.gov/webfiles/20686/QRM_FINAL_ALL_R41111.pdf

Our analysis estimated the number of loans that would and would not have met the QRM standard in each year and calculates the percentages of those loans that have been 90 days or more delinquent so far. Loans meeting the QRM standards varied from close to 10 percent of Enterprise acquisitions that were originated during the boom years when underwriting standards were lower, to about 31 percent for 2009 originations, or 27 percent when considering only purchase loans. The debt-to-income ratios had the strongest impact on the share of loans meeting the QRM standard. However, that result may reflect some underreporting of income by applicants who knew that they would qualify for the loan without reporting higher income.

FHFA also evaluated the impact of varying the required down payment from 20 percent.. Lowering the QRM's minimum down payment to only 10 percent would have increased the share of qualifying Enterprise loans used for home purchase by just 5 percentage points, from 27 percent to 32 percent. The additional loans would be much riskier, though. Their ever-90-days delinquency rates were consistently 2 to 2.5 times higher than the rates for QRM loans. Because these were all Enterprise loans, virtually all of the loans with LTVs above 80 percent had mortgage insurance, so allowing higher LTV loans only if they had mortgage insurance would not have improved the results.

Concerns have been raised about the impact this standard would have on the availability or cost of finance for homebuyers who are unable to put down 20 percent of the purchase price. The agencies expect to receive a significant number of comments on this issue and will consider them carefully before issuing a final rule. Loans that do not achieve QRM status and are not purchased by an Enterprise or guaranteed by FHA would subject securitizers to the higher costs associated with risk retention, and those costs might well be passed on to borrowers.

In evaluating the potential impact of risk retention, it is important to distinguish between the effect of existing risk-based pricing and the effects that might be caused by risk retention. Some commentaries on the proposed rule indicate that only borrowers who can put 20 percent down will be able to get the best rates. But significant differences in rates based on credit risk already exist today. Freddie Mac, for example, will pay its best price only for loans with LTVs of 60 percent or less and borrower FICO scores of 700 or more.

In considering how much risk retention might add to borrowers' costs, it is well to keep in mind that interest rates on jumbo loans, which do not currently have any serious securitization options--QRM or non-QRM-- available, have been about 60 basis points above those on the largest loans available for securitization through Fannie Mae or Freddie Mac. In effect, that spread is currently the cost of not being able to securitize any portion of those loans. It seems reasonable to anticipate that in a market environment that is receptive to private label securities, risk retention would have a much smaller effect on mortgage rates because it would only prevent lenders from securitizing five percent of their loans.

As required by the Dodd-Frank Act, the standards that define QRM are associated with a low risk of default based on historical data. Investors should be willing to purchase securities backed by pools of such mortgages without the retention of credit risk by the securitizer. However, because QRM has been defined in the NPR as the best class of loans, rather than an average class of loans, there should continue to be many loans made to creditworthy borrowers that fall outside of the QRM standards. The five percent risk retention requirement on securities backed by such loans will help to increase investor confidence and encourage originators and securitizers to maintain prudent underwriting standards, without the race to the bottom that was prevalent in the boom years.

While the proposed QRM standard requires a 20 percent down payment and does not recognize mortgage insurance as a source of meaningful reductions in mortgage defaults, FHFA expects that securitizers and investors will continue to recognize the value of mortgage insurance and other credit enhancements as a vehicle for the reduction of loss severity in the event of default. Therefore, borrowers should continue to have access to mortgage credit without making a 20 percent down payment.

**Forms of Risk Retention for Non-QRM Loans**

The agencies have proposed in the NPR more than one way for securitizers to satisfy the risk retention requirement for non-QRM loans. The NPR provides a menu of options that would allow the market to determine the most appropriate form of risk retention for a particular deal that satisfies the needs of the investor community, at the lowest cost to the securitizer. This will

benefit market liquidity and may allow the market to develop a consensus on risk retention over time.

A securitizer may meet the risk retention requirements for residential mortgage loans through an unhedged five percent of the credit risk in the form of:

- A vertical slice with pro-rata exposure to each class,
- A horizontal slice consisting of the most subordinate class or classes,
- A combination of vertical and horizontal slices, or
- A randomly selected sample of loans.

The NPR allows a securitizer to share the retained risk by allocating a portion of the requirement to originators, but only to originators that provide at least 20 percent of the aggregate loan balances and take at least 20 percent of the retained risk. The rule also allows for resecuritizations of existing securities without the retention of credit risk, but only for structures that result in a single class that simply passes through the cash flows of the underlying securities, rather than redistributing the credit risk between classes.

Finally, the NPR includes a premium recapture account, which comprises any proceeds of more than 95 percent of the par value of the securities. This would discourage security structures that permit the securitizer to take a substantial profit up front at the time of securitization. Structures that would provide an immediate gain on sale to the securitizer would need to include a special reserve account into which the entire surplus derived from the sale of the securities would be deposited, and funds in that account would be available to cover losses before any were imposed on investors. Structures giving the securitizers immediate cash gains were widely abused during the boom, and they generated some of the worst losses. The premium capture account requirement is designed to prevent such abuses by ensuring that the securitizer has a continuing interest in the performance of the underlying assets.

**Treatment of Enterprise Securities**

Although the Act authorizes the agencies to make exemptions separate and apart from the statutory exemption that applies to Ginnie Mae securities, the NPR does not exempt the Enterprises from the risk retention requirements. However, the proposed rule allows the full guarantee of the credit risk by Fannie Mae and Freddie Mac on their single-family mortgage-backed securities (MBS) to qualify as a permissible form of risk retention while they are in conservatorship with financial support from the U.S. Treasury.

The 100 percent risk retention by the Enterprises on their guaranteed MBS is obviously the maximum possible and far exceeds the five percent retention required by Section 941. Therefore, the NPR does not classify all of the Enterprises' loans as qualified residential mortgages, but rather acknowledges that the risk retention by the Enterprises on almost all of their securities is already complete. Furthermore, since the risk retained by the Enterprises is itself backed by the Treasury through the Senior Preferred Stock Purchase Agreements and not by private capital, it is stronger than any other form of 100 percent risk retention by a private corporation.

The Enterprises' guarantees and the backing of the U.S. Treasury appear to provide the necessary protection for investors and the proposed treatment of Enterprise MBS would thus be in the public interest. Retention of five percent of the securities issued would not result in a greater alignment of Enterprise interests with those of investors, and it would be inconsistent with the Enterprises' agreements with the Treasury that require a 10 percent per year wind down in mortgage assets held for investment by each Enterprise. Simply excluding assets held for the purpose of meeting the risk retention rule from the retained portfolio for the purpose meeting the portfolio reduction targets would prevent forced sales of other assets or violations of the agreements, but it would not address the purpose of these provisions of the agreements with Treasury, which was to reduce the size of the Enterprises' retained portfolios to limit taxpayer risks.

It seems unlikely that requiring the Enterprises to hold five percent of their newly issued securities would encourage private capital to enter the market to any significant degree. The

added Enterprise costs would be only a few basis points, at most, and taxpayers would bear increased interest rate and operational risks from larger retained portfolios. There are more efficient and effective means to reduce the market share of the Enterprises and boost private participation in the secondary mortgage market. Congress has been considering a number of ways to lessen the government's role in housing finance over time, including increasing guarantee fees over time and reducing the conforming loan limit. The Administration's February 2011 white paper, "Reforming America's Housing Finance Market," discussed these and other possible approaches. Since being placed into conservatorship, the Enterprises' underwriting standards have been strengthened and several price increases have been initiated to better align pricing with risk. FHFA will continue to evaluate further changes along these lines, and we will continue to work with Congress on evaluating legislative approaches to encourage greater private sector participation.

**Some Comments on the Mortgage Servicing Requirements for QRMs**

The proposed rule includes several loan servicing requirements that must be met to receive QRM treatment. These address important problems in the servicing of mortgages that must be corrected, but they are not meant to constitute an exhaustive list that solves all problems. Indeed, as proposed, the requirements only apply to loans that are securitized as QRMs. Separately, FHFA has been working with the Enterprises to align the requirements that each places on its loan servicers, incorporating emerging best practices. At the same time, we have been working with the Enterprises and HUD to consider more effective methods of compensating servicers, and we have held discussions with other regulators as part of an effort to establish national servicing standards. The requirements in this proposal should be viewed as part of a much broader process of reform in mortgage servicing.

I will be happy to answer any questions you may have.

Mortgage Market Note

Qualified Residential Mortgages

April 11, 2011

# MORTGAGE MARKET NOTE 11-02[1]

## Introduction

One important purpose of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is to reform the securitization of financial assets in the U.S. [2] To that end, the legislation requires the federal banking agencies, the Securities and Exchange Commission, the Secretary of Housing and Urban Development, and the Federal Housing Finance Agency ("the Agencies") to jointly issue regulations to require securitizers to retain an economic interest in a portion of the credit risk for residential mortgages that they use to collateralize asset-backed securities. Dodd-Frank requires the Agencies to exempt securities from this requirement that are backed only by loans with low default risk that meet a Qualified Residential Mortgage (QRM) standard.

The Agencies must jointly define what constitutes a QRM "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default." To help the public consider the definition set forth in the recently-published Notice of Proposed Rulemaking ("NPR") that would implement the risk retention provision of Dodd-Frank, this data release provides historical data on loan volumes and ever-90-day[3] delinquency rates of mortgages purchased or guaranteed by Fannie Mae or Freddie Mac ("the Enterprises").

## Purpose

Given the proposed standard of a QRM exemption to the risk retention rule contained in Dodd-Frank, the data in this release provide broad answers to the questions:

[1] This Mortgage Market Note revises and corrects the March 31, 2011 Mortgage Market Note: Qualified Residential Mortgages. Revisions were made to the final two paragraphs of text concerning the marginal ever-90-day delinquency rates resulting from small adjustments to the proposed Qualified Residential Mortgage standards, as well as the bullet point that summarizes the key finding, "Expanding QRM Definitions Would Add Loans with Much Poorer Performance". Additional tables were also added (see Section 4c), which were not included in the prior version.

[2] See Pub. L. No. 111-203, § 941, 124 Stat. 1376, 1890-1896 (2010) of the Dodd-Frank Act. See also, S. Rep. 111-176 at 128-131 (2010) (discussing subtitle D of title IX of the Dodd-Frank Act).

[3] A mortgage is ever-90-day delinquent if it has had a payment 90 days past-due or longer, has been put into foreclosure or transferred as a deed-in-lieu of foreclosure, or has been classified as a real-estate-owned (REO) property after an unsuccessful sale at a foreclosure auction at any point in the life of the loan through September of 2010. The dataset contains monthly information on the number of days each delinquent mortgage is past due and whether loans are in foreclosure processing. However, mortgages are identified as being in REO only at the end of each quarter.

- What is the volume and performance of conventional single-family mortgages acquired by the Enterprises in recent years that would have met the proposed requirements, and how does this compare to the volume and performance of loans that would not have met the proposed requirements, and to overall volume and performance?

- How have the volume and performance of proposed QRM loans changed over time, especially with respect to typical years versus the housing boom years?

- How does the volume and performance of proposed QRM mortgages change when small adjustments are made to the qualification standards?

The analysis here does not attempt to estimate how overall loan volumes might have been affected if risk retention requirements had been in place, or how interest rates on QRM loans might differ from those on non-QRM loans.

## Key Findings

This data release examines the volume and performance of all first-lien, single-family mortgages, and the subset of QRM eligible mortgages, acquired by the Enterprises from 1997 through 2009. The following analysis does not fully capture the restrictions of the interagency QRM proposal, although it attempts to come as close as possible, given the limitations of available data. Therefore, when necessary, the analysis utilizes approximations for the proposed QRM standards. For example, credit score(s) for the borrower(s) calculated using models developed by Fair Isaac Corporation (FICO) at loan origination are used as a proxy variable for borrower credit history as the dataset used does not capture detailed credit bureau information on a borrower's credit performance. An appendix summarizes the data used to prepare the analysis, which reaches the following broad conclusions:

### QRM Shares Were Lowest During the Boom Years

- About 30.5 percent of conventional single-family mortgages originated in 2009 and subsequently acquired by the Enterprises would have met the proposed QRM standards. The QRM shares were lower in 1997 through 2008. Prior to the beginning of the housing boom in 2004, the years with the highest QRM shares were 1998 (23.3 percent) and 2003 (24.6 percent).

### Delinquencies Were Higher for Non-QRM Loans, but Highest in 2004 to 2008 Non-QRM Loans

- Ever-90-day delinquencies for non-QRM loans originated during the 13 years considered here were 6 to 12 times as frequent as ever-90-day delinquencies for QRM loans. Prior to the housing boom, mortgages originated in 1997 through 2003 and subsequently acquired by the Enterprises that would have met the proposed QRM standards had an ever-90-day delinquency rate ranging from 0.3 percent to 0.6 percent. In the same period, the ever-90-day delinquency rate for loans that would not have met the proposed standard ranged from 2.6 percent to 3.7 percent.

- Mortgages originated in 2004 through 2008 and subsequently acquired by the Enterprises that would have met the proposed QRM standards had an ever-90-day delinquency rate ranging from 0.7 percent to 2.7 percent. In the same period, the ever-90-day delinquency rate for loans that would not have met the proposed QRM standard ranged from 6.2 percent to 21.5 percent.

**Risk-Factors Contributing to Poor Performance of Non-QRM Loans Varied from Typical Years to Boom Years**

- For the 2005-2007 origination years, the requirement for product-type (no non-traditional and low documentation loans, or loans for houses not occupied by the owner) was the QRM risk factor that most reduced delinquency rates. For most origination years, requirements for borrower credit score and loan-to-value ratio are the factors that most reduce the ever-90-day delinquency rate of mortgages acquired by the Enterprises that would have met the proposed QRM standards.

**Debt-to-Income Ratios are Most Restrictive Factor within Proposed QRM Definition**

- Among the factors that the NPR uses to define a QRM, the requirement that excludes the most mortgages is that which limits the borrower's front-end and back-end debt-to-income ratios, which may in part reflect a tendency for the borrower and/or lender to report an income that met the minimum underwriting requirement and no more.

**Expanding QRM Definitions Would Add Loans with Much Poorer Performance**

- Loans that would have met QRM standards except for having loan-to-value ratios above 80 percent but less than 90 percent had ever-90-day delinquency rates that ranged from 2.0 to 3.9 times as great as QRM loans originated in the same year. Relaxing the PTI/DTI requirement from 28/36 to 30/38 would have resulted in delinquency rates up to 2.1 times as great as for QRM loans.

## Risk-Factors in Historic Loan Performance Data

The following data analysis describes how the QRM exemption requirements reduce the occurrence of delinquent mortgages relative to non-qualifying mortgages. In addition, the analysis describes how relaxing or tightening the risk-factors changes the QRM volume and ever-90-day delinquencies. The data come from FHFA's Historical Loan Performance ("HLP") dataset, which contains loan-level information on the characteristics and performance of all single-family mortgages acquired by the Enterprises.[4] FHFA updates the Historical Loan Performance dataset quarterly with information from each Enterprise.

[4] The Historical Loan Performance dataset does not include loans backing private-label MBS bought by the Enterprises.

The loans used for the analysis comprise nearly 75 million mortgages and had an aggregate unpaid principal balance at origination of $11.9 trillion.

*Defining Risk-Factor Requirements for Analysis*

The HLP dataset contains information on factors that lenders use to assess mortgage credit risk at origination and information on subsequent loan performance. Risk-factors include the product-type, payment-to-income and debt-to-income (PTI/DTI) ratios at origination, initial loan-to-value (LTV) ratios based on the purchase price or appraised property value and the first-lien balance, and credit score(s) for the borrower(s) calculated using models developed by Fair Isaac Corporation (FICO). We define each risk-factor as the following:

- A **Product-Type qualified residential mortgage** is a first-lien mortgage that is for an owner-occupant with fully documented income, fully amortizing with a maturity that does not exceed 30 years and, in the case of adjustable-rate-mortgages (ARMs), has an interest rate reset limit of 2 percent annually and a limit of 6 percent over the life of the loan. Under QRM, loans may not be alternative-A (Alt-A, most of which are low- or no-document) mortgages, interest-only (IO) mortgages, negatively amortizing mortgages such as payment option-ARMs, or balloon mortgages. Therefore, loans with these characteristics are disqualified regardless of other risk-factor qualification.

- A **PTI/DTI qualified residential mortgage** has a borrower's ratio of monthly housing debt to monthly gross income that does not exceed 28 percent and a borrower's total monthly debt to monthly gross income that does not exceed 36 percent.
    - Payment-to-income ratio, otherwise known as front-end DTI, is the sum of the borrowers' monthly payment for principal, interest, taxes, and insurance divided by the total gross monthly income of all borrowers as determined at the time of origination.
    - Debt-to-Income ratio, or back-end DTI, is similar to payment-to-income but adds all other fixed debts into the numerator of the ratio.

- An **LTV ratio qualified residential mortgage** must meet a minimum LTV ratio that varies according to the purpose for which the mortgage was originated. For home purchase mortgages, rate and term refinances, and cash-out refinances, the LTV ratios are 80, 75, and 70 percent, respectively.

- A **FICO qualified residential mortgage** has a borrower's FICO score greater than or equal to 690 at the origination of the loan. The HLP dataset does not record delinquency history, prior bankruptcy of foreclosure, etc. of borrowers in the loans analyzed. For this reason, using a threshold of 690

for the FICO of the borrower at origination is a proxy for the absent detailed credit bureau data.

*Data Limitations*

The HLP data used for this analysis contains information on first lien mortgages, but does not indicate if a subordinate lien is present, so that some loans with combined LTV ratios greater than the QRM maximums will be missed and loans with equal reported LTV ratios may pose different credit risk. This data limitation is probably not a serious shortcoming for the years 1997 to, roughly, 2003, or for 2008 and 2009, as comparatively few junior liens were originated in those years. But for the peak years of the housing boom, 2004-2007, effects on volume and delinquency reduction are probably both understated. In addition, the PTI and DTI calculations use Enterprise definitions of income and debt payments, which may differ slightly from the definitions used in the NPR. Finally, the Enterprises did not always require full interior appraisals for low risk originations, and this risk-factor is not captured in the following analysis. However, it is likely that originators will respond to the proposed regulations by requiring full appraisals for loans that otherwise meet the QRM standards, so this is not likely to be a serious limitation of the analysis.

Mortgages missing either FICO scores or LTV ratios comprise 0.9 percent and 0.2 percent of the principal of all mortgages in the dataset. However, the percentage of mortgages missing either a front-end or back-end debt-to-income ratios for all years in the full dataset is 3.9 percent. Given the percentage of low- or no-document loans between 2004 and 2008, a significant portion of the missing observations are disqualified by the product-type qualification requirement in those years. The product-type requirement reduces the total missing for PTI/DTI to 2.2 percent. However, having the stipulation that loans must be fully-documented, the remaining mortgages that have missing observations, regardless of qualification in other risk factors, are rendered to non-qualified status. Therefore, the QRM qualified set of mortgages does not have any missing data.

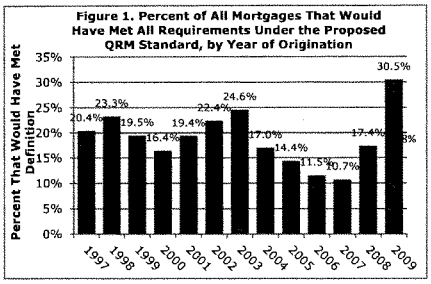
**Analysis of Mortgages Acquired by the Enterprises**

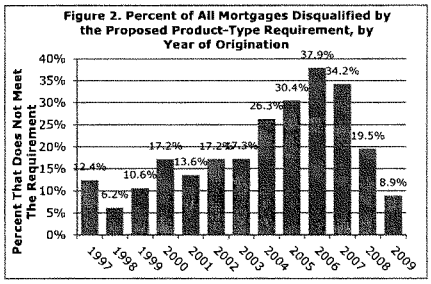
*Volume of QRM-Qualified and Non-Qualified Loans*

The first set of tables in Appendix A (Section 1) provide information on the volume of QRM-qualified and non-QRM qualified loans by origination year. When interpreting this table, it is important to understand that there is significant overlap across each column. For example, a mortgage that meets the PTI/DTI requirement may also meet the FICO requirement and therefore be captured in both columns. The first column shows the unrestricted volume of mortgages and the percentages in the subsequent columns reflect the volume of mortgages that would qualify for a single requirement, without restricting the data with the other three QRM requirements. About 19.8 percent of conventional single-family mortgages originated in 1997 through 2009 and subsequently acquired by

the Enterprises would have met the proposed QRM standards. The origination year with the highest QRM share was in 2009 (30.5 percent) (see Figure 1).

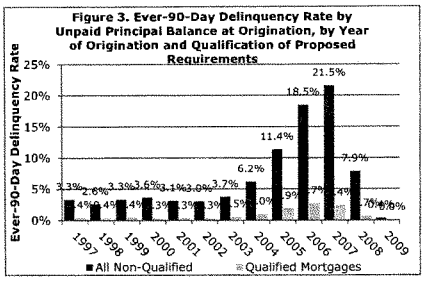
Prior to the beginning of the housing boom in 2004, the years with the highest QRM shares were 1998 (23.3 percent) and 2003 (24.6 percent). The percentage of mortgages originated from 2004 into 2008 that would have been disqualified by the product-type requirement (that is, mortgages with little or no documentation, interest only or negative amortization mortgages, etc.) is much higher than in other years. In figure 2, the percentages range from a low of 6.2 percent in 1998 to a peak of 37.9 percent in 2006. This observation reflects how the timing of the housing boom coincided with an increase in the volume of non-traditional and low-documentation loans as well as loans secured by investors. The shift in the boom years contrasts with the periods before and after, where higher concentrations of delinquencies in groups consist of mortgages with traditional payment-types.

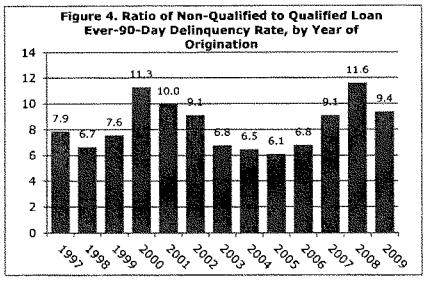



*Ever-90-Day Delinquency Rates of QRM-Qualified and Non-Qualified Loans*

Similarly, the second set of tables in the Appendix A (Section 2) provide information on the ever-90-day delinquency rates for the same groups as the tables in section A. The ever 90-day delinquency rates should be interpreted with caution. Relative comparisons of those rates are likely to be most revealing within origination years for two reasons. First, ever 90-day delinquency rates can only increase as time passes, so rates for recent years are understated relative to those for earlier years. Second, rates for groups of mortgages that appear identical at origination but were originated in different years may have different performance because economic conditions vary over time. For example, low interest rates and rapid house price appreciation allowed many borrowers who took out loans during times of peak house price appreciation to refinance their loans, reducing the ever 90-day delinquency rates of mortgages in those origination years relative to those loans taken at the end of the period.



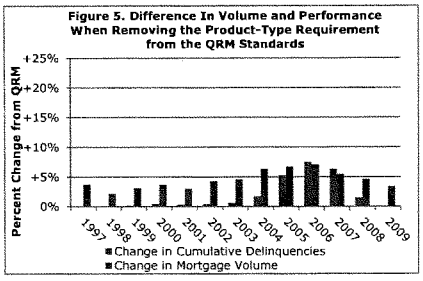

Prior to the housing boom, mortgages originated in 1997 through 2003 and subsequently acquired by the Enterprises that would have met the proposed QRM standard had an ever-90-day delinquency rate ranging from 0.3 percent to 0.5 percent (see Figure 3). In the same period, the ever-90-day delinquency rate for non-qualified loans (those that would not have met the proposed requirements) ranged from 2.6 percent to 3.7 percent. During the housing boom, mortgages originated in 2004 through 2008 and subsequently acquired by the Enterprises that would have met the proposed QRM standards had an ever-90-day delinquency rate ranging from 0.7 percent to 2.7 percent (see Figure 3). In the same period, the average delinquency rate for loans that would not have met the proposed standard ranged from 6.2 percent to 21.5 percent. The ratio of delinquency rates for non-qualified residential mortgages to qualified residential mortgages range from 6.1 to 11.6 for all years and reach peaks in 2000 and 2008 (see Figure 4).

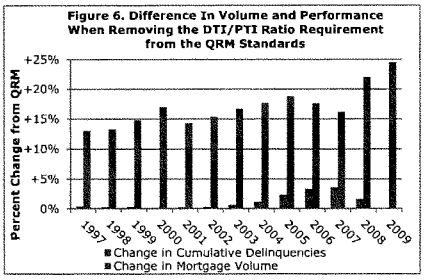
*Impact of Removing One of the Risk-Factors*

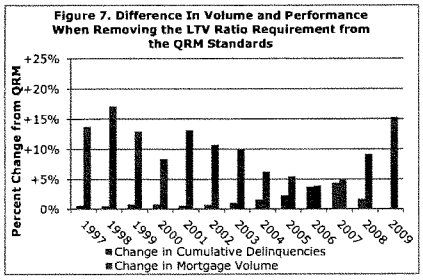
The third set of tables in the Appendix A (Section 3) combine the information on the volumes and ever-90-day delinquency rates found in the previous two sets of tables to show the effect of removing one requirement while holding all others at their respective QRM levels. The first column shows the delinquency rate, or volume, for loans that appear eligible for QRM treatment under the proposed regulation. The last column shows the increase in total delinquency rate or total volume from removing all QRM requirements. The intermediate columns show the effect of removing one criterion from the proposed QRM standard. For example, the column headed FICO score shows the extent to which delinquency rates, and loan volume, would increase if all aspects of the QRM standards were maintained, except for the limitation on credit history (as proxied by the FICO score).

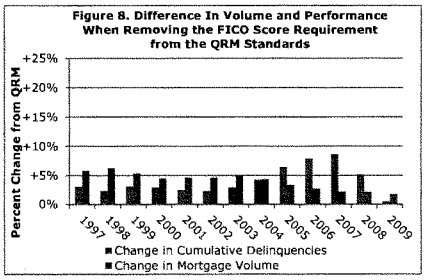
The ever-90-day delinquency rates for mortgages originated from 2004 into 2008 are concentrated in the non-product-type QRM groups of mortgages (see Figure 5). When the PTI/DTI requirement is removed from the QRM standards, the percent change in the volume of mortgages increases significantly in comparison to the change in ever-90-day

delinquency rates (see Figure 6), which, as noted earlier, may reflect on the reporting of income by the borrower and/or lender at the time of origination. Leaving aside mortgages originated in 2005-2007, which were much more likely to have non-traditional payment terms than loans originated in other years, borrower credit score and LTV ratio are the factors that most reduce the ever-90-day delinquency rate of mortgages that would have met the proposed QRM standard (see Figures 7, 8).


Figure 5. Difference In Volume and Performance When Removing the Product-Type Requirement from the QRM Standards
Percent Change from QRM
+25%
+20%
+15%
+10%
+5%
0%
1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009
Change in Cumulative Delinquencies
Change in Mortgage Volume


Figure 6. Difference In Volume and Performance When Removing the DTI/PTI Ratio Requirement from the QRM Standards
Percent Change from QRM
+25%
+20%
+15%
+10%
+5%
0%
1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009
Change in Cumulative Delinquencies
Change in Mortgage Volume


Figure 7. Difference In Volume and Performance When Removing the LTV Ratio Requirement from the QRM Standards
Percent Change from QRM
+25%
+20%
+15%
+10%
+5%
0%
1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009
Change in Cumulative Delinquencies
Change in Mortgage Volume

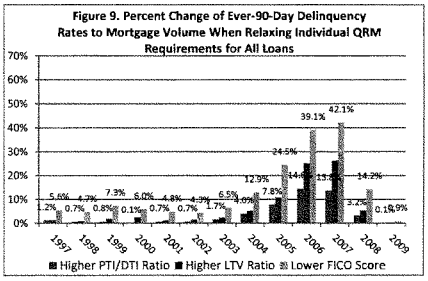

Figure 8. Difference In Volume and Performance When Removing the FICO Score Requirement from the QRM Standards
Percent Change from QRM
+25%
+20%
+15%
+10%
+5%
0%
1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009
Change in Cumulative Delinquencies
Change in Mortgage Volume

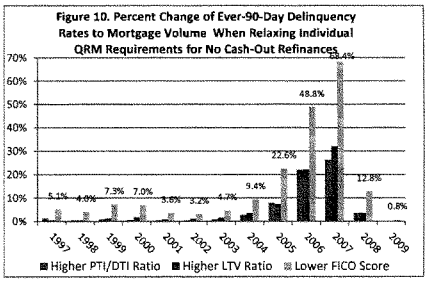
*Impact of Adjusting One of the Risk-Factors*

Where the previous tables provide information on the exclusion of one or more of the requirements, the final set of tables in the Appendix A (Sections 4a, 4b and 4c) provide a brief description of the sensitivity of volume and performance, by year, to small adjustments to the QRM requirements. To assess changes to the risk-factors, the analysis relaxes or tightens each requirement. For the relaxed qualifications, adjustments to the minimum PTI/DTI ratios move from 28/36 to 30/38, the maximum LTV ratios move from 80, 75, and 70 percent to 90, 85, and 80 percent, respectively, and the minimum FICO score changes from 690 to 660. For the tighter qualifications, adjustments to the minimum PTI/DTI ratios move to 26/34, the maximum LTV ratios move to 70, 65, and 60 percent, respectively, and the minimum FICO score changes to 720. While some of the adjustments are targeted to evaluate specific policy discussions, all of the adjustments

reflect an attempt to provide context to the proposed QRM standards on which this data release is based.

The first column in tables 4a and 4b shows the ever-90-day delinquency rates for QRMs and subsequent columns provide information on the effect of changing one standard, while holding the others constant. For example, the "Higher DTI" column in the delinquency portion of the tables in section 4a shows the effect relaxing the PTI/DTI standard. Applying a less stringent PTI/DTI standard, while holding all other proposed QRM standards constant, raises the delinquency rate by a few basis points over the rate shown in the first column, where all QRM standards are applied as per the interagency proposal. The second section of the table shows the effect on mortgage lending volume (measured in unpaid principle balance terms) from changing one standard while holding others constant. The final three columns show the tradeoff between the changes in volume and the changes in delinquency that result from an adjustment to one of the standards. These columns display the ratio of the change in delinquency to the change in total volume. The second to last column in the Purchases table of section 4a shows that a relaxation of the LTV ratio requirement from 80 to 90 percent in 1997, holding all other requirements equal to the proposed QRM standards, produces a rate of change for an ever-90-day delinquency of 1.63 basis points for every 1 percentage point change to volume. More specifically, the ever-90-day delinquency rate in 1997 increases from 0.42 percent to 0.51 percent if the maximum LTV Ratio moves from 80 to 90 percent; the increase in default cost may be absorbed by Private Mortgage Insurance (PMI) but the ever-90-day delinquency rate nevertheless increases.




The effects of altering the proposed QRM standards during the boom years are different from the effects in more typical years, sometimes substantially so. For example, in section in 2007 at the height of the housing boom, lowering the FICO requirement from 690 to 660 would have increased the delinquency rate by 42 basis points for each percentage point increase in volume. From 1997 to 2002, relaxing the FICO standard would have only increased ever-90-day delinquency rates from between 4.3 and 7.3 basis points for each percentage point increase in volume. For those same years, relaxing the PTI/DTI

risk-factor requirement from 28/36 to 30/38 would have increased ever-90-day delinquency rates from between 0.7 and 1.2 basis points for each percentage point increase in volume (see Figure 9). An adjustment to the PTI/DTI requirements would affect ever-90-day delinquency rates less than an adjustment to any other proposed QRM requirement. In contrast, ever-90-day delinquency rates related to FICO score, especially for no cash-out refinances during the housing boom years shown in figure 10, are the most sensitive to an adjustment to the QRM requirements.

Loans that were just beyond the proposed QRM requirements had substantially higher ever-90-day delinquency rates than did loans that met all of the proposed QRM requirements. For example, Section 4c of the Appendix A shows that during the peak years of the boom, 2004 to 2007, purchase loans that met all requirements had an ever-90-day delinquency rate ranging from 1.16 to 2.33 percent, while purchase loans that met all requirements except that their LTV ratios were higher, between 80 and 90 percent, than the proposed QRM requirement, had an ever-90-day delinquency rate ranging from 2.66 to 5.51 percent, about 2.0 to 2.3 times the percent for QRM eligible loans. Even for the more typical years, 1997 to 2002, this finding is persistent as loans with an LTV ratio between 80 and 90 percent are still about 2.0 to 2.5 times more delinquent than the proposed QRM eligible loans.

Similarly, from 2004 to 2007, all loans that met the proposed QRM requirements had an ever-90-day delinquency rate ranging from 0.95 to 2.72 percent, while loans that met all requirements except that their PTI/DTI ratios were between 28/36 and 30/38 percent had an ever-90-day delinquency rate ranging from 1.72 to 4.68 percent, about 1.7 to 1.8 times the percent for QRM eligible loans. In the 1997 to 2002 time period, loans with these higher PTI/DTI ratios had delinquencies rates between 1.1 and 1.7 times the percent for QRM eligible loans.

# APPENDIX A SECTION 1: PERCENT OF UNPAID-PRINCIPAL-BALANCE BY PROPOSED REQUIREMENT QUALIFICATION

ALL LOANS

| Year | All Loans | Percent of Mortgages that Do Not Qualify for the Following Requirements | | | | All Non-Qualified | Percent of Mortgages that Qualify for the the Following Requirements | | | | Qualified Mortgages |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Product-Type | PTI/DTI | LTV | FICO | | Product-Type | PTI/DTI | LTV | FICO | |
| 1997 | $ 286,497,878,371 | 12.43% | 44.44% | 46.59% | 33.40% | 79.56% | 87.57% | 55.56% | 53.41% | 66.60% | 20.44% |
| 1998 | $ 691,033,994,509 | 6.17% | 40.94% | 47.28% | 30.56% | 76.71% | 93.83% | 59.06% | 52.72% | 69.44% | 23.29% |
| 1999 | $ 481,450,519,442 | 10.64% | 48.88% | 46.59% | 32.76% | 80.52% | 89.36% | 51.12% | 53.41% | 67.24% | 19.48% |
| 2000 | $ 356,779,731,420 | 17.19% | 57.53% | 44.46% | 34.63% | 83.56% | 82.81% | 42.47% | 55.54% | 65.37% | 16.44% |
| 2001 | $ 1,039,412,013,403 | 13.57% | 49.68% | 48.62% | 31.63% | 80.63% | 86.43% | 50.32% | 51.38% | 68.37% | 19.37% |
| 2002 | $ 1,385,056,256,240 | 17.17% | 48.58% | 41.89% | 28.94% | 77.63% | 82.83% | 51.42% | 58.11% | 71.06% | 22.37% |
| 2003 | $ 1,924,265,340,603 | 17.26% | 47.56% | 37.12% | 26.69% | 75.43% | 82.74% | 52.44% | 62.88% | 73.31% | 24.57% |
| 2004 | $ 937,643,914,289 | 26.31% | 57.38% | 36.25% | 31.02% | 82.97% | 73.69% | 42.62% | 63.75% | 68.98% | 17.03% |
| 2005 | $ 939,069,358,457 | 30.43% | 62.68% | 35.16% | 29.31% | 85.59% | 69.57% | 37.32% | 64.84% | 70.69% | 14.41% |
| 2006 | $ 887,443,942,464 | 37.93% | 67.28% | 35.78% | 31.21% | 88.48% | 62.07% | 32.72% | 64.22% | 68.79% | 11.52% |
| 2007 | $ 1,027,460,511,244 | 34.21% | 69.10% | 45.58% | 32.26% | 89.28% | 65.79% | 30.90% | 54.42% | 67.74% | 10.72% |
| 2008 | $ 793,136,249,487 | 19.52% | 62.19% | 40.68% | 18.18% | 82.61% | 80.48% | 37.81% | 59.32% | 81.82% | 17.39% |
| 2009 | $ 1,176,445,135,548 | 8.89% | 47.02% | 33.67% | 7.57% | 69.48% | 91.11% | 52.98% | 66.33% | 92.43% | 30.52% |

PURCHASES

| Year | All Loans | Percent of Mortgages that Do Not Qualify for the Following Requirements | | | | All Non-Qualified | Percent of Mortgages that Qualify for the the Following Requirements | | | | Qualified Mortgages |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Product-Type | PTI/DTI | LTV | FICO | | Product-Type | PTI/DTI | LTV | FICO | |
| 1997 | $ 171,316,168,314 | 13.58% | 45.87% | 44.31% | 32.65% | 79.26% | 86.42% | 54.13% | 55.69% | 67.35% | 20.74% |
| 1998 | $ 243,827,154,269 | 7.91% | 45.45% | 44.20% | 31.84% | 77.92% | 92.09% | 54.55% | 55.80% | 68.16% | 22.08% |
| 1999 | $ 252,736,885,540 | 12.76% | 51.89% | 42.26% | 30.30% | 80.14% | 87.24% | 48.11% | 57.74% | 69.70% | 19.86% |
| 2000 | $ 259,462,348,244 | 16.94% | 57.68% | 39.65% | 31.24% | 81.83% | 83.06% | 42.32% | 60.35% | 68.76% | 18.17% |
| 2001 | $ 334,671,388,428 | 17.10% | 55.24% | 39.04% | 31.11% | 80.43% | 82.90% | 44.76% | 60.96% | 68.89% | 19.57% |
| 2002 | $ 378,648,800,742 | 22.98% | 56.73% | 35.83% | 30.48% | 81.57% | 77.02% | 43.27% | 64.17% | 69.52% | 18.43% |
| 2003 | $ 428,404,858,343 | 25.58% | 57.77% | 33.43% | 29.23% | 81.97% | 74.42% | 42.23% | 66.57% | 70.77% | 18.03% |
| 2004 | $ 397,943,548,815 | 31.83% | 60.61% | 26.98% | 27.49% | 83.29% | 68.17% | 39.39% | 73.02% | 72.51% | 16.71% |
| 2005 | $ 433,917,427,310 | 36.81% | 63.50% | 21.97% | 24.48% | 84.33% | 63.19% | 36.50% | 78.03% | 75.52% | 15.67% |
| 2006 | $ 459,040,004,449 | 39.62% | 67.67% | 22.43% | 26.51% | 86.43% | 60.38% | 32.33% | 77.57% | 73.49% | 13.57% |
| 2007 | $ 504,879,485,500 | 33.63% | 70.36% | 36.93% | 28.80% | 87.61% | 66.37% | 29.64% | 63.07% | 71.20% | 12.39% |
| 2008 | $ 321,485,446,505 | 20.83% | 64.91% | 34.49% | 16.19% | 82.67% | 79.17% | 35.09% | 65.51% | 83.81% | 17.33% |
| 2009 | $ 225,983,942,704 | 15.38% | 54.40% | 18.84% | 8.24% | 72.94% | 84.62% | 45.60% | 81.16% | 91.76% | 27.06% |

NO CASHOUT REFINANCES

| Year | All Loans | Percent of Mortgages that Do Not Qualify for the Following Requirements | | | | All Non-Qualified | Percent of Mortgages that Qualify for the the Following Requirements | | | | Qualified Mortgages |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Product-Type | PTI/DTI | LTV | FICO | | Product-Type | PTI/DTI | LTV | FICO | |
| 1997 | $ 72,883,400,278 | 11.21% | 41.91% | 48.39% | 33.33% | 78.96% | 88.79% | 58.09% | 51.61% | 66.67% | 21.04% |
| 1998 | $ 302,723,323,315 | 5.51% | 37.65% | 47.08% | 29.44% | 74.76% | 94.49% | 62.35% | 52.92% | 70.56% | 25.24% |
| 1999 | $ 140,480,199,806 | 8.21% | 44.65% | 49.13% | 35.44% | 79.66% | 91.79% | 55.35% | 50.87% | 64.56% | 20.34% |
| 2000 | $ 48,878,241,470 | 15.43% | 56.56% | 54.50% | 42.38% | 86.34% | 84.57% | 43.44% | 45.50% | 57.62% | 13.66% |
| 2001 | $ 390,566,245,690 | 10.81% | 44.63% | 48.40% | 29.49% | 77.44% | 89.19% | 55.37% | 51.60% | 70.51% | 22.56% |
| 2002 | $ 584,998,514,202 | 14.25% | 41.83% | 37.47% | 24.64% | 71.31% | 85.75% | 58.17% | 62.53% | 75.36% | 28.69% |
| 2003 | $ 920,098,549,172 | 14.00% | 40.54% | 32.81% | 22.18% | 68.94% | 86.00% | 59.46% | 67.19% | 77.82% | 31.06% |
| 2004 | $ 269,562,391,201 | 20.63% | 49.47% | 36.64% | 28.13% | 77.63% | 79.37% | 50.53% | 63.36% | 71.87% | 22.37% |
| 2005 | $ 169,162,254,192 | 25.31% | 57.10% | 43.13% | 29.16% | 83.58% | 74.69% | 42.90% | 56.87% | 70.84% | 16.42% |
| 2006 | $ 131,792,837,483 | 38.68% | 63.97% | 49.03% | 31.93% | 89.76% | 61.32% | 36.03% | 50.97% | 68.07% | 10.24% |
| 2007 | $ 196,852,210,903 | 37.90% | 66.82% | 53.69% | 32.36% | 90.59% | 62.10% | 33.18% | 46.31% | 67.64% | 9.41% |
| 2008 | $ 231,714,054,542 | 19.75% | 57.54% | 41.02% | 16.17% | 79.84% | 80.25% | 42.46% | 58.98% | 83.83% | 20.16% |
| 2009 | $ 637,544,819,174 | 7.97% | 43.87% | 35.65% | 6.77% | 67.20% | 92.03% | 56.13% | 64.35% | 93.23% | 32.80% |

CASHOUT REFINANCES

| Year | All Loans | Percent of Mortgages that Do Not Qualify for the Following Requirements | | | | All Non-Qualified | Percent of Mortgages that Qualify for the the Following Requirements | | | | Qualified Mortgages |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Product-Type | PTI/DTI | LTV | FICO | | Product-Type | PTI/DTI | LTV | FICO | |
| 1997 | $ 42,298,309,778 | 9.87% | 43.04% | 52.72% | 36.55% | 81.83% | 90.13% | 56.96% | 47.28% | 63.45% | 18.17% |
| 1998 | $ 144,483,516,925 | 4.63% | 40.25% | 52.90% | 30.76% | 78.75% | 95.37% | 59.75% | 47.10% | 69.24% | 21.25% |
| 1999 | $ 88,233,434,096 | 8.40% | 46.99% | 54.94% | 35.53% | 82.95% | 91.60% | 53.01% | 45.06% | 64.47% | 17.05% |
| 2000 | $ 48,439,141,706 | 20.33% | 57.76% | 60.10% | 44.96% | 89.97% | 79.67% | 42.24% | 39.90% | 55.04% | 10.03% |
| 2001 | $ 314,174,379,286 | 13.25% | 50.04% | 59.10% | 34.84% | 84.81% | 86.75% | 49.96% | 40.90% | 65.16% | 15.19% |
| 2002 | $ 421,408,941,296 | 16.00% | 50.63% | 53.49% | 33.54% | 82.87% | 84.00% | 49.37% | 46.51% | 66.46% | 17.13% |
| 2003 | $ 575,761,933,088 | 16.29% | 51.18% | 46.76% | 32.01% | 80.95% | 83.71% | 48.82% | 53.24% | 67.99% | 19.05% |
| 2004 | $ 270,137,974,274 | 23.86% | 60.53% | 49.49% | 39.08% | 87.84% | 76.14% | 39.47% | 50.51% | 60.92% | 12.16% |
| 2005 | $ 335,989,676,955 | 24.77% | 64.44% | 48.19% | 35.62% | 88.23% | 75.23% | 35.56% | 51.81% | 64.38% | 11.77% |
| 2006 | $ 296,611,100,532 | 34.97% | 68.14% | 50.55% | 38.16% | 91.07% | 65.03% | 31.86% | 49.45% | 61.84% | 8.93% |
| 2007 | $ 325,728,814,842 | 32.87% | 68.53% | 54.09% | 37.58% | 91.07% | 67.13% | 31.47% | 45.91% | 62.42% | 8.93% |
| 2008 | $ 239,936,748,440 | 17.53% | 63.04% | 48.63% | 22.78% | 85.22% | 82.47% | 36.96% | 51.37% | 77.22% | 14.78% |
| 2009 | $ 312,916,373,670 | 6.10% | 48.11% | 40.34% | 8.70% | 71.64% | 93.90% | 51.89% | 59.66% | 91.30% | 28.36% |

## SECTION 2: EVER-90-DAY DELINQUENCY RATES BY PROPOSED REQUIREMENT QUALIFICATION

### ALL LOANS

| Year | All Loans | Mortgages that Do Not Qualify for the Following Requirements | | | | All Non-Qualified | Mortgages that Qualify for the the Following Requirements | | | | Qualified Mortgages |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Product-Type | PTI/DTI | LTV | FICO | | Product-Type | PTI/DTI | LTV | FICO | |
| 1997 | 2.72% | 1.78% | 3.55% | 4.19% | 6.37% | 3.31% | 2.85% | 2.05% | 1.43% | 0.88% | 0.42% |
| 1998 | 2.06% | 1.62% | 2.74% | 3.08% | 4.97% | 2.57% | 2.09% | 1.59% | 1.15% | 0.78% | 0.39% |
| 1999 | 2.75% | 2.06% | 3.42% | 4.22% | 6.31% | 3.30% | 2.83% | 2.10% | 1.46% | 1.01% | 0.44% |
| 2000 | 3.09% | 4.37% | 3.71% | 5.12% | 7.02% | 3.64% | 2.83% | 2.25% | 1.47% | 1.01% | 0.32% |
| 2001 | 2.59% | 4.29% | 3.40% | 4.00% | 6.20% | 3.13% | 2.32% | 1.79% | 1.25% | 0.92% | 0.31% |
| 2002 | 2.42% | 3.34% | 3.21% | 4.14% | 5.92% | 3.03% | 2.23% | 1.68% | 1.19% | 1.00% | 0.33% |
| 2003 | 2.94% | 3.68% | 3.99% | 5.09% | 6.96% | 3.72% | 2.79% | 2.00% | 1.68% | 1.48% | 0.55% |
| 2004 | 5.29% | 6.59% | 6.59% | 8.62% | 10.44% | 6.18% | 4.82% | 3.54% | 3.40% | 2.97% | 0.95% |
| 2005 | 9.99% | 14.52% | 12.11% | 14.56% | 17.79% | 11.36% | 8.01% | 6.44% | 7.52% | 6.76% | 1.86% |
| 2006 | 16.65% | 24.47% | 19.70% | 24.26% | 27.98% | 18.47% | 11.88% | 10.38% | 12.41% | 11.51% | 2.72% |
| 2007 | 19.49% | 28.28% | 23.49% | 28.85% | 33.67% | 21.55% | 14.92% | 10.54% | 11.65% | 12.74% | 2.37% |
| 2008 | 6.62% | 9.09% | 8.95% | 11.18% | 17.99% | 7.87% | 6.02% | 2.79% | 3.49% | 4.09% | 0.68% |
| 2009 | 0.28% | 0.34% | 0.46% | 0.50% | 1.62% | 0.39% | 0.28% | 0.12% | 0.17% | 0.17% | 0.04% |

### PURCHASES

| Year | All Loans | Mortgages that Do Not Qualify for the Following Requirements | | | | All Non-Qualified | Mortgages that Qualify for the the Following Requirements | | | | Qualified Mortgages |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Product-Type | PTI/DTI | LTV | FICO | | Product-Type | PTI/DTI | LTV | FICO | |
| 1997 | 2.87% | 1.68% | 3.66% | 4.72% | 6.88% | 3.50% | 3.05% | 2.19% | 1.39% | 0.92% | 0.42% |
| 1998 | 2.59% | 1.68% | 3.19% | 4.19% | 6.07% | 3.20% | 2.67% | 2.10% | 1.33% | 0.97% | 0.46% |
| 1999 | 2.62% | 1.78% | 3.17% | 4.40% | 6.44% | 3.18% | 2.75% | 2.04% | 1.33% | 0.96% | 0.40% |
| 2000 | 2.59% | 3.54% | 3.13% | 4.66% | 6.39% | 3.09% | 2.39% | 1.85% | 1.22% | 0.86% | 0.29% |
| 2001 | 2.97% | 4.65% | 3.72% | 5.34% | 7.15% | 3.61% | 2.63% | 2.06% | 1.46% | 1.09% | 0.38% |
| 2002 | 3.18% | 3.82% | 3.79% | 6.07% | 7.31% | 3.79% | 2.99% | 2.39% | 1.57% | 1.37% | 0.48% |
| 2003 | 4.43% | 4.33% | 5.38% | 8.48% | 9.73% | 5.20% | 4.47% | 3.13% | 2.40% | 2.25% | 0.93% |
| 2004 | 5.87% | 6.73% | 7.22% | 11.53% | 12.20% | 6.81% | 5.47% | 3.79% | 3.78% | 3.47% | 1.16% |
| 2005 | 10.74% | 15.22% | 13.05% | 17.78% | 20.16% | 12.34% | 8.13% | 6.73% | 8.76% | 7.69% | 2.13% |
| 2006 | 16.39% | 24.25% | 19.69% | 25.63% | 30.20% | 18.53% | 11.22% | 9.48% | 13.71% | 11.40% | 2.76% |
| 2007 | 18.84% | 26.76% | 23.00% | 31.05% | 35.95% | 21.18% | 14.83% | 8.97% | 11.70% | 11.92% | 2.33% |
| 2008 | 6.26% | 7.66% | 8.24% | 12.40% | 18.53% | 7.44% | 5.89% | 2.59% | 3.03% | 3.89% | 0.64% |
| 2009 | 0.30% | 0.36% | 0.41% | 0.48% | 1.75% | 0.38% | 0.29% | 0.17% | 0.25% | 0.17% | 0.07% |

NO CASHOUT REFINANCES

| Year | All Loans | Mortgages that Do Not Qualify for the Following Requirements | | | | All Non-Qualified | Mortgages that Qualify for the the Following Requirements | | | | Qualified Mortgages |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Product-Type | PTI/DTI | LTV | FICO | | Product-Type | PTI/DTI | LTV | FICO | |
| 1997 | 2.37% | 1.85% | 3.31% | 3.40% | 5.65% | 2.90% | 2.43% | 1.69% | 1.40% | 0.73% | 0.37% |
| 1998 | 1.74% | 1.45% | 2.49% | 2.57% | 4.39% | 2.22% | 1.76% | 1.29% | 1.01% | 0.64% | 0.33% |
| 1999 | 2.94% | 2.43% | 3.87% | 4.31% | 6.40% | 3.57% | 2.98% | 2.18% | 1.61% | 1.03% | 0.46% |
| 2000 | 4.51% | 6.92% | 5.53% | 6.42% | 8.76% | 5.16% | 4.07% | 3.19% | 2.22% | 1.38% | 0.40% |
| 2001 | 2.24% | 3.55% | 3.14% | 3.56% | 5.74% | 2.81% | 2.08% | 1.51% | 0.99% | 0.77% | 0.27% |
| 2002 | 1.91% | 2.66% | 2.81% | 3.60% | 5.34% | 2.56% | 1.78% | 1.26% | 0.89% | 0.78% | 0.28% |
| 2003 | 2.17% | 2.87% | 3.16% | 3.98% | 5.86% | 2.94% | 2.05% | 1.49% | 1.28% | 1.11% | 0.46% |
| 2004 | 4.13% | 5.74% | 5.47% | 6.76% | 9.04% | 5.09% | 3.71% | 2.81% | 2.60% | 2.20% | 0.77% |
| 2005 | 7.97% | 12.33% | 9.96% | 11.55% | 15.04% | 9.26% | 6.49% | 5.32% | 5.26% | 5.06% | 1.43% |
| 2006 | 16.73% | 25.19% | 19.70% | 22.95% | 26.30% | 18.32% | 11.39% | 11.46% | 10.74% | 12.24% | 2.74% |
| 2007 | 22.30% | 32.88% | 26.61% | 30.07% | 33.92% | 24.32% | 15.85% | 13.63% | 13.31% | 16.75% | 2.86% |
| 2008 | 6.48% | 10.40% | 9.29% | 10.57% | 17.91% | 7.94% | 5.52% | 2.67% | 3.64% | 4.28% | 0.70% |
| 2009 | 0.28% | 0.31% | 0.49% | 0.54% | 1.71% | 0.40% | 0.28% | 0.12% | 0.14% | 0.18% | 0.04% |

CASHOUT REFINANCES

| Year | All Loans | Mortgages that Do Not Qualify for the Following Requirements | | | | All Non-Qualified | Mortgages that Qualify for the the Following Requirements | | | | Qualified Mortgages |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Product-Type | PTI/DTI | LTV | FICO | | Product-Type | PTI/DTI | LTV | FICO | |
| 1997 | 2.72% | 2.22% | 3.50% | 3.62% | 5.69% | 3.21% | 2.77% | 2.12% | 1.71% | 1.00% | 0.51% |
| 1998 | 1.83% | 1.86% | 2.39% | 2.48% | 4.20% | 2.22% | 1.83% | 1.46% | 1.11% | 0.78% | 0.39% |
| 1999 | 2.79% | 2.70% | 3.51% | 3.71% | 5.85% | 3.25% | 2.80% | 2.15% | 1.67% | 1.10% | 0.52% |
| 2000 | 4.39% | 6.07% | 5.05% | 5.55% | 7.75% | 4.82% | 3.95% | 3.47% | 2.63% | 1.64% | 0.51% |
| 2001 | 2.61% | 4.56% | 3.30% | 3.50% | 5.77% | 3.02% | 2.31% | 1.92% | 1.32% | 0.92% | 0.31% |
| 2002 | 2.46% | 3.55% | 3.08% | 3.50% | 5.39% | 2.90% | 2.25% | 1.82% | 1.26% | 0.98% | 0.31% |
| 2003 | 3.08% | 4.05% | 3.87% | 4.53% | 6.31% | 3.68% | 2.89% | 2.25% | 1.80% | 1.56% | 0.51% |
| 2004 | 5.60% | 7.06% | 6.56% | 7.65% | 9.61% | 6.25% | 5.14% | 4.12% | 3.58% | 3.02% | 0.89% |
| 2005 | 10.04% | 14.32% | 11.87% | 14.02% | 16.81% | 11.16% | 8.64% | 6.74% | 6.34% | 6.30% | 1.70% |
| 2006 | 17.03% | 24.49% | 19.73% | 23.88% | 26.22% | 18.44% | 13.01% | 11.25% | 10.02% | 11.35% | 2.61% |
| 2007 | 18.80% | 27.50% | 22.44% | 25.80% | 30.82% | 20.43% | 14.54% | 10.88% | 10.55% | 11.56% | 2.14% |
| 2008 | 7.24% | 9.94% | 9.63% | 10.53% | 17.54% | 8.37% | 6.66% | 3.16% | 4.12% | 4.20% | 0.72% |
| 2009 | 0.27% | 0.40% | 0.45% | 0.42% | 1.38% | 0.37% | 0.26% | 0.10% | 0.17% | 0.17% | 0.03% |

# SECTION 3: THE EFFECT OF REMOVING INDIVIDUAL REQUIREMENTS

## ALL LOANS

Change in the QRM Ever-90-Day Delinquency Rate When Removing One of the Qualification Requirements

| Year | QRM Delinquency Rate | Product Type | PTI/DTI | LTV | FICO | All Req'ts |
|---|---|---|---|---|---|---|
| 1997 | 0.42% | +0.05% | +0.39% | +0.61% | +3.08% | +2.30% |
| 1998 | 0.39% | +0.10% | +0.31% | +0.52% | +2.34% | +1.68% |
| 1999 | 0.44% | +0.13% | +0.34% | +0.78% | +3.12% | +2.31% |
| 2000 | 0.32% | +0.43% | +0.20% | +0.83% | +2.94% | +2.77% |
| 2001 | 0.31% | +0.35% | +0.27% | +0.59% | +2.52% | +2.27% |
| 2002 | 0.33% | +0.41% | +0.32% | +0.73% | +2.34% | +2.09% |
| 2003 | 0.55% | +0.64% | +0.66% | +1.06% | +2.95% | +2.40% |
| 2004 | 0.95% | +1.72% | +1.16% | +1.58% | +4.27% | +4.33% |
| 2005 | 1.86% | +5.30% | +2.36% | +2.31% | +6.46% | +8.13% |
| 2006 | 2.72% | +7.49% | +3.35% | +3.73% | +7.90% | +13.93% |
| 2007 | 2.37% | +6.34% | +3.59% | +4.39% | +8.66% | +17.12% |
| 2008 | 0.68% | +1.48% | +1.64% | +1.68% | +5.15% | +5.94% |
| 2009 | 0.04% | +0.06% | +0.11% | +0.09% | +0.50% | +0.24% |

Change in the Total QRM Dollar Volume When Removing One of the Qualification Requirements

| Year | QRM Volume | Product Type | PTI/DTI | LTV | FICO | All Loans |
|---|---|---|---|---|---|---|
| 1997 | 20.44% | +3.75% | +13.04% | +13.74% | +5.81% | $ 286,497,878,371 |
| 1998 | 23.29% | +2.17% | +13.30% | +17.10% | +6.24% | $ 691,033,994,509 |
| 1999 | 19.48% | +3.16% | +14.83% | +12.95% | +5.37% | $ 481,450,519,442 |
| 2000 | 16.44% | +3.70% | +17.00% | +8.40% | +4.53% | $ 356,779,731,420 |
| 2001 | 19.37% | +3.01% | +14.33% | +13.11% | +4.62% | $ 1,039,412,013,403 |
| 2002 | 22.37% | +4.28% | +15.35% | +10.72% | +4.62% | $ 1,385,056,256,240 |
| 2003 | 24.57% | +4.55% | +16.68% | +10.02% | +4.98% | $ 1,924,265,340,603 |
| 2004 | 17.03% | +6.35% | +17.68% | +6.25% | +4.34% | $ 937,643,914,289 |
| 2005 | 14.41% | +6.74% | +18.78% | +5.45% | +3.36% | $ 939,069,358,457 |
| 2006 | 11.52% | +7.11% | +17.59% | +3.91% | +2.73% | $ 887,443,942,464 |
| 2007 | 10.72% | +5.44% | +16.14% | +4.95% | +2.24% | $ 1,027,460,511,244 |
| 2008 | 17.39% | +4.64% | +22.01% | +9.22% | +2.12% | $ 793,136,249,487 |
| 2009 | 30.52% | +3.38% | +24.47% | +15.26% | +1.74% | $ 1,176,445,135,548 |

## PURCHASES

| Year | QRM Delinquency Rate | Product Type | PTI/DTI | LTV | FICO | All Req'ts |
|---|---|---|---|---|---|---|
| 1997 | 0.42% | +0.03% | +0.36% | +0.80% | +3.13% | +2.44% |
| 1998 | 0.46% | +0.04% | +0.30% | +0.90% | +2.70% | +2.13% |
| 1999 | 0.40% | +0.12% | +0.30% | +0.98% | +3.05% | +2.23% |
| 2000 | 0.29% | +0.38% | +0.17% | +0.83% | +2.51% | +2.29% |
| 2001 | 0.38% | +0.35% | +0.28% | +0.97% | +2.72% | +2.59% |
| 2002 | 0.48% | +0.50% | +0.32% | +1.28% | +2.61% | +2.70% |
| 2003 | 0.93% | +0.72% | +0.78% | +1.84% | +3.29% | +3.50% |
| 2004 | 1.16% | +1.97% | +1.24% | +2.53% | +3.93% | +4.71% |
| 2005 | 2.13% | +6.18% | +2.49% | +2.87% | +5.94% | +8.61% |
| 2006 | 2.76% | +8.69% | +3.28% | +3.29% | +6.78% | +13.63% |
| 2007 | 2.33% | +6.76% | +3.31% | +4.33% | +6.79% | +16.51% |
| 2008 | 0.64% | +1.36% | +1.42% | +2.10% | +4.73% | +5.62% |
| 2009 | 0.07% | +0.09% | +0.09% | +0.07% | +0.63% | +0.23% |

| Year | QRM Volume | Product Type | PTI/DTI | LTV | FICO | All Loans |
|---|---|---|---|---|---|---|
| 1997 | 20.74% | +4.40% | +14.02% | +12.11% | +5.55% | $ 171,316,168,314 |
| 1998 | 22.08% | +2.99% | +15.33% | +13.09% | +6.23% | $ 243,827,154,269 |
| 1999 | 19.86% | +4.02% | +17.29% | +10.39% | +4.93% | $ 252,736,885,540 |
| 2000 | 18.17% | +4.21% | +19.37% | +7.56% | +4.45% | $ 259,462,348,244 |
| 2001 | 19.57% | +4.20% | +18.76% | +7.94% | +4.92% | $ 334,671,388,428 |
| 2002 | 18.43% | +5.80% | +18.86% | +6.12% | +4.51% | $ 378,648,800,742 |
| 2003 | 18.03% | +6.81% | +19.38% | +5.32% | +4.42% | $ 428,404,858,343 |
| 2004 | 16.71% | +9.21% | +20.88% | +3.25% | +3.78% | $ 397,943,548,815 |
| 2005 | 15.67% | +10.22% | +22.25% | +2.51% | +2.92% | $ 433,917,427,310 |
| 2006 | 13.57% | +9.37% | +21.75% | +2.02% | +2.48% | $ 459,040,004,449 |
| 2007 | 12.39% | +6.88% | +19.94% | +3.27% | +1.95% | $ 504,879,485,500 |
| 2008 | 17.33% | +6.08% | +26.06% | +6.40% | +1.86% | $ 321,485,446,505 |
| 2009 | 27.06% | +7.02% | +33.83% | +8.18% | +1.89% | $ 225,983,942,704 |

NO CASHOUT REFINANCES

Change in the QRM Ever-90-Day Delinquency Rate When Removing One of the Qualification Requirements

| Year | QRM Delinquency Rate | Product Type | PTI/DTI | LTV | FICO | All Req'ts |
|---|---|---|---|---|---|---|
| 1997 | 0.37% | +0.06% | +0.43% | +0.32% | +2.94% | +2.00% |
| 1998 | 0.33% | +0.11% | +0.27% | +0.36% | +2.15% | +1.41% |
| 1999 | 0.46% | +0.17% | +0.43% | +0.66% | +3.26% | +2.47% |
| 2000 | 0.40% | +0.66% | +0.31% | +0.70% | +3.69% | +4.11% |
| 2001 | 0.27% | +0.32% | +0.24% | +0.50% | +2.21% | +1.97% |
| 2002 | 0.28% | +0.27% | +0.28% | +0.65% | +2.01% | +1.63% |
| 2003 | 0.46% | +0.42% | +0.54% | +0.88% | +2.69% | +1.71% |
| 2004 | 0.77% | +1.01% | +0.97% | +1.25% | +4.09% | +3.36% |
| 2005 | 1.43% | +3.09% | +1.92% | +1.96% | +6.46% | +6.54% |
| 2006 | 2.74% | +6.44% | +3.70% | +3.72% | +8.57% | +13.99% |
| 2007 | 2.86% | +7.94% | +5.20% | +5.39% | +10.27% | +19.45% |
| 2008 | 0.70% | +1.80% | +1.94% | +1.55% | +5.25% | +5.78% |
| 2009 | 0.04% | +0.03% | +0.11% | +0.10% | +0.48% | +0.24% |

Change in the Total QRM Dollar Volume When Removing One of the Qualification Requirements

| Year | QRM Volume | Product Type | PTI/DTI | LTV | FICO | All Loans |
|---|---|---|---|---|---|---|
| 1997 | 21.04% | +3.12% | +11.92% | +15.76% | +6.12% | $ 72,883,400,278 |
| 1998 | 25.24% | +1.92% | +12.34% | +18.72% | +6.40% | $ 302,723,323,315 |
| 1999 | 20.34% | +2.44% | +12.42% | +14.98% | +6.23% | $ 140,480,199,806 |
| 2000 | 13.66% | +2.31% | +11.72% | +10.37% | +5.06% | $ 48,878,241,470 |
| 2001 | 22.56% | +2.89% | +13.21% | +15.14% | +4.72% | $ 390,566,245,690 |
| 2002 | 28.69% | +4.46% | +15.27% | +11.65% | +4.90% | $ 584,998,514,202 |
| 2003 | 31.06% | +4.48% | +16.76% | +11.22% | +5.22% | $ 920,098,549,172 |
| 2004 | 22.37% | +5.15% | +16.81% | +8.76% | +5.07% | $ 269,562,391,201 |
| 2005 | 16.42% | +4.93% | +16.06% | +8.46% | +3.82% | $ 169,162,254,192 |
| 2006 | 10.24% | +6.22% | +13.03% | +6.20% | +2.73% | $ 131,792,837,483 |
| 2007 | 9.41% | +5.15% | +12.27% | +6.36% | +2.16% | $ 196,852,210,903 |
| 2008 | 20.16% | +4.61% | +20.18% | +10.87% | +2.06% | $ 231,714,054,542 |
| 2009 | 32.80% | +3.01% | +22.10% | +16.44% | +1.63% | $ 637,544,819,174 |

CASHOUT REFINANCES

| Year | QRM Delinquency Rate | Product Type | PTI/DTI | LTV | FICO | All Req'ts |
|---|---|---|---|---|---|---|
| 1997 | 0.51% | +0.18% | +0.48% | +0.54% | +3.12% | +2.20% |
| 1998 | 0.39% | +0.20% | +0.37% | +0.42% | +2.09% | +1.44% |
| 1999 | 0.52% | +0.23% | +0.42% | +0.56% | +3.05% | +2.27% |
| 2000 | 0.51% | +0.70% | +0.41% | +0.81% | +4.26% | +3.88% |
| 2001 | 0.31% | +0.33% | +0.23% | +0.52% | +2.67% | +2.30% |
| 2002 | 0.31% | +0.40% | +0.28% | +0.61% | +2.57% | +2.15% |
| 2003 | 0.51% | +0.64% | +0.60% | +1.12% | +3.11% | +2.57% |
| 2004 | 0.89% | +1.29% | +1.08% | +1.51% | +4.92% | +4.71% |
| 2005 | 1.70% | +2.71% | +2.22% | +2.55% | +7.11% | +8.34% |
| 2006 | 2.61% | +3.77% | +3.34% | +4.05% | +9.06% | +14.42% |
| 2007 | 2.14% | +3.46% | +3.37% | +3.84% | +9.99% | +16.66% |
| 2008 | 0.72% | +1.39% | +1.73% | +1.44% | +5.47% | +6.52% |
| 2009 | 0.03% | +0.05% | +0.10% | +0.07% | +0.44% | +0.24% |

| Year | QRM Volume | Product Type | PTI/DTI | LTV | FICO | All Loans |
|---|---|---|---|---|---|---|
| 1997 | 18.17% | +2.23% | +10.98% | +16.86% | +6.32% | $ 42,298,309,778 |
| 1998 | 21.25% | +1.30% | +11.88% | +20.45% | +5.91% | $ 144,483,516,925 |
| 1999 | 17.05% | +1.84% | +11.63% | +17.04% | +5.28% | $ 88,233,434,096 |
| 2000 | 10.03% | +2.40% | +9.66% | +10.90% | +4.46% | $ 48,439,141,706 |
| 2001 | 15.19% | +1.90% | +11.01% | +16.10% | +4.18% | $ 314,174,379,286 |
| 2002 | 17.13% | +2.67% | +12.30% | +13.58% | +4.33% | $ 421,408,941,296 |
| 2003 | 19.05% | +2.99% | +14.53% | +11.60% | +5.00% | $ 575,761,933,088 |
| 2004 | 12.16% | +3.34% | +13.83% | +8.15% | +4.43% | $ 270,137,974,274 |
| 2005 | 11.77% | +3.14% | +15.67% | +7.74% | +3.71% | $ 335,989,676,955 |
| 2006 | 8.93% | +4.00% | +13.17% | +5.81% | +3.12% | $ 296,611,100,532 |
| 2007 | 8.93% | +3.39% | +12.61% | +6.70% | +2.75% | $ 325,728,814,842 |
| 2008 | 14.78% | +2.75% | +18.34% | +11.41% | +2.52% | $ 239,936,748,440 |
| 2009 | 28.36% | +1.52% | +22.56% | +17.99% | +1.87% | $ 312,916,373,670 |

## SECTION 4a. THE EFFECT OF RELAXING INDIVIDUAL REQUIREMENTS

### ALL LOANS

| Year | QRM Delinquency Rate | Change in the Ever-90-Day Delinquency Rates After Decreasing Each Requirement: Higher DTI | Higher LTV | Lower FICO | Year | QRM Volume | Change in the Total QRM Dollar Volume After Decreasing Each Requirement: Higher DTI | Higher LTV | Lower FICO | All Loans | Percent Change of Delinquency Rate to Mortgage Volume: Higher DTI | Higher LTV | Lower FICO |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1997 | 0.42% | +0.03% | +0.11% | +0.15% | 1997 | 20.44% | +2.70% | +8.81% | +2.64% | $ 286,497,878,371 | 1.22% | 1.28% | 5.59% |
| 1998 | 0.39% | +0.02% | +0.12% | +0.13% | 1998 | 23.29% | +2.46% | +12.51% | +2.74% | $ 691,033,994,510 | 0.66% | 0.92% | 4.73% |
| 1999 | 0.44% | +0.02% | +0.17% | +0.18% | 1999 | 19.48% | +2.28% | +8.64% | +2.51% | $ 481,450,519,437 | 0.77% | 1.92% | 7.32% |
| 2000 | 0.32% | +0.00% | +0.12% | +0.12% | 2000 | 16.44% | +2.32% | +4.75% | +2.00% | $ 356,779,731,419 | 0.10% | 2.50% | 5.95% |
| 2001 | 0.31% | +0.01% | +0.12% | +0.10% | 2001 | 19.37% | +2.02% | +9.84% | +2.16% | $ 1,039,412,013,402 | 0.73% | 1.17% | 4.78% |
| 2002 | 0.33% | +0.01% | +0.13% | +0.10% | 2002 | 22.37% | +2.12% | +8.47% | +2.22% | $ 1,385,056,256,237 | 0.68% | 1.51% | 4.34% |
| 2003 | 0.55% | +0.04% | +0.19% | +0.15% | 2003 | 24.57% | +2.16% | +7.98% | +2.27% | $ 1,924,265,340,603 | 1.66% | 2.43% | 6.54% |
| 2004 | 0.95% | +0.08% | +0.25% | +0.25% | 2004 | 17.03% | +2.08% | +4.72% | +1.95% | $ 937,643,914,292 | 4.02% | 5.23% | 12.94% |
| 2005 | 1.86% | +0.17% | +0.46% | +0.39% | 2005 | 14.41% | +2.15% | +4.26% | +1.60% | $ 939,069,358,458 | 7.80% | 10.76% | 24.54% |
| 2006 | 2.72% | +0.28% | +0.74% | +0.50% | 2006 | 11.52% | +1.93% | +2.93% | +1.28% | $ 887,443,942,463 | 14.57% | 25.17% | 39.07% |
| 2007 | 2.37% | +0.24% | +0.88% | +0.44% | 2007 | 10.72% | +1.71% | +3.33% | +1.04% | $ 1,027,460,511,244 | 13.75% | 26.30% | 42.13% |
| 2008 | 0.68% | +0.08% | +0.37% | +0.16% | 2008 | 17.39% | +2.41% | +6.91% | +1.13% | $ 793,136,249,488 | 3.24% | 5.34% | 14.18% |
| 2009 | 0.04% | +0.00% | +0.02% | +0.01% | 2009 | 30.52% | +3.17% | +12.43% | +1.14% | $ 1,176,445,135,544 | 0.14% | 0.13% | 0.87% |

### PURCHASES

| Year | QRM Delinquency Rate | Higher DTI | Higher LTV | Lower FICO | Year | QRM Volume | Higher DTI | Higher LTV | Lower FICO | All Loans | Higher DTI | Higher LTV | Lower FICO |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1997 | 0.42% | +0.03% | +0.09% | +0.14% | 1997 | 20.74% | +2.98% | +5.39% | +2.52% | $ 171,316,168,315 | 1.06% | 1.63% | 5.51% |
| 1998 | 0.46% | +0.02% | +0.10% | +0.15% | 1998 | 22.08% | +2.85% | +5.42% | +2.63% | $ 243,827,154,269 | 0.54% | 1.92% | 5.71% |
| 1999 | 0.40% | +0.01% | +0.10% | +0.16% | 1999 | 19.86% | +2.67% | +4.27% | +2.35% | $ 252,736,885,537 | 0.52% | 2.42% | 6.96% |
| 2000 | 0.29% | +0.00% | +0.06% | +0.10% | 2000 | 18.17% | +2.68% | +3.21% | +2.07% | $ 259,462,348,244 | 0.00% | 1.95% | 4.94% |
| 2001 | 0.38% | +0.02% | +0.08% | +0.13% | 2001 | 19.57% | +2.61% | +3.16% | +2.31% | $ 334,671,388,428 | 0.67% | 2.52% | 5.64% |
| 2002 | 0.48% | +0.02% | +0.08% | +0.13% | 2002 | 18.43% | +2.50% | +2.37% | +2.19% | $ 378,648,800,742 | 0.83% | 3.34% | 5.92% |
| 2003 | 0.93% | +0.07% | +0.11% | +0.23% | 2003 | 18.03% | +2.42% | +1.95% | +1.89% | $ 428,404,858,343 | 2.80% | 5.50% | 11.96% |
| 2004 | 1.16% | +0.10% | +0.10% | +0.26% | 2004 | 16.71% | +2.51% | +1.22% | +1.82% | $ 397,943,548,817 | 4.05% | 8.35% | 14.17% |
| 2005 | 2.13% | +0.18% | +0.14% | +0.36% | 2005 | 15.67% | +2.59% | +0.98% | +1.58% | $ 433,917,427,309 | 7.00% | 14.09% | 22.93% |
| 2006 | 2.76% | +0.28% | +0.14% | +0.45% | 2006 | 13.57% | +2.41% | +0.75% | +1.35% | $ 459,040,004,449 | 11.63% | 19.23% | 33.15% |
| 2007 | 2.33% | +0.23% | +0.19% | +0.36% | 2007 | 12.39% | +2.13% | +1.04% | +1.06% | $ 504,879,485,501 | 10.99% | 18.04% | 34.23% |
| 2008 | 0.64% | +0.07% | +0.29% | +0.16% | 2008 | 17.33% | +2.77% | +3.26% | +1.07% | $ 321,485,446,506 | 2.53% | 8.96% | 15.23% |
| 2009 | 0.07% | +0.01% | +0.01% | +0.02% | 2009 | 27.06% | +3.94% | +5.34% | +1.21% | $ 225,983,942,702 | 0.16% | 0.23% | 1.47% |

NO CASHOUT REFINANCES

| Year | Change in the Ever-90-Day Delinquency Rates After Decreasing Each Requirement: QRM Delinquency Rate | Higher DTI | Higher LTV | Lower FICO | Year | Change in the Total QRM Dollar Volume After Decreasing Each Requirement: QRM Volume | Higher DTI | Higher LTV | Lower FICO | All Loans | Percent Change of Delinquency Rate to Mortgage Volume: Higher DTI | Higher LTV | Lower FICO |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1997 | 0.37% | +0.03% | +0.07% | +0.15% | 1997 | 21.04% | +2.36% | +12.34% | +2.87% | $ 72,883,400,278 | 1.48% | 0.55% | 5.11% |
| 1998 | 0.33% | +0.01% | +0.09% | +0.11% | 1998 | 25.24% | +2.31% | +14.60% | +2.87% | $ 302,723,323,316 | 0.47% | 0.62% | 4.01% |
| 1999 | 0.46% | +0.02% | +0.16% | +0.21% | 1999 | 20.34% | +1.91% | +11.53% | +2.84% | $ 140,480,199,805 | 1.01% | 1.43% | 7.27% |
| 2000 | 0.40% | +0.01% | +0.15% | +0.14% | 2000 | 13.66% | +1.58% | +7.99% | +2.01% | $ 48,878,241,470 | 0.66% | 1.88% | 7.01% |
| 2001 | 0.27% | +0.01% | +0.10% | +0.08% | 2001 | 22.56% | +1.90% | +11.93% | +2.28% | $ 390,566,245,688 | 0.63% | 0.88% | 3.58% |
| 2002 | 0.28% | +0.01% | +0.12% | +0.08% | 2002 | 28.69% | +2.20% | +9.63% | +2.48% | $ 584,998,514,198 | 0.50% | 1.23% | 3.17% |
| 2003 | 0.46% | +0.02% | +0.17% | +0.12% | 2003 | 31.06% | +2.22% | +9.33% | +2.54% | $ 920,098,549,171 | 1.06% | 1.80% | 4.72% |
| 2004 | 0.77% | +0.06% | +0.27% | +0.22% | 2004 | 22.37% | +1.98% | +7.44% | +2.35% | $ 269,562,391,200 | 2.80% | 3.59% | 9.42% |
| 2005 | 1.43% | +0.14% | +0.54% | +0.40% | 2005 | 16.42% | +1.78% | +7.31% | +1.76% | $ 169,162,254,193 | 7.86% | 7.44% | 22.57% |
| 2006 | 2.74% | +0.32% | +1.19% | +0.60% | 2006 | 10.24% | +1.45% | +5.35% | +1.23% | $ 131,792,837,483 | 22.07% | 22.33% | 48.77% |
| 2007 | 2.86% | +0.34% | +1.64% | +0.69% | 2007 | 9.41% | +1.30% | +5.11% | +1.01% | $ 196,852,210,902 | 26.26% | 32.04% | 68.37% |
| 2008 | 0.70% | +0.09% | +0.33% | +0.15% | 2008 | 20.16% | +2.39% | +8.77% | +1.17% | $ 231,714,054,542 | 3.69% | 3.76% | 12.79% |
| 2009 | 0.04% | +0.00% | +0.01% | +0.01% | 2009 | 32.80% | +3.02% | +12.36% | +1.09% | $ 637,544,819,173 | 0.15% | 0.11% | 0.77% |

CASHOUT REFINANCES

| Year | QRM Delinquency Rate | Higher DTI | Higher LTV | Lower FICO | Year | QRM Volume | Higher DTI | Higher LTV | Lower FICO | All Loans | Higher DTI | Higher LTV | Lower FICO |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1997 | 0.51% | +0.03% | +0.25% | +0.19% | 1997 | 18.17% | +2.16% | +16.55% | +2.77% | $ 42,298,309,778 | 1.62% | 1.51% | 6.86% |
| 1998 | 0.39% | +0.03% | +0.20% | +0.13% | 1998 | 21.25% | +2.13% | +20.09% | +2.67% | $ 144,483,516,926 | 1.21% | 0.99% | 4.84% |
| 1999 | 0.52% | +0.03% | +0.26% | +0.20% | 1999 | 17.05% | +1.72% | +16.54% | +2.42% | $ 88,233,434,095 | 1.81% | 1.56% | 8.33% |
| 2000 | 0.51% | +0.02% | +0.31% | +0.24% | 2000 | 10.03% | +1.15% | +9.72% | +1.64% | $ 48,439,141,706 | 1.88% | 3.24% | 14.44% |
| 2001 | 0.31% | +0.01% | +0.18% | +0.10% | 2001 | 15.19% | +1.54% | +14.35% | +1.84% | $ 314,174,379,286 | 0.78% | 1.24% | 5.60% |
| 2002 | 0.31% | +0.01% | +0.20% | +0.10% | 2002 | 17.13% | +1.66% | +12.32% | +1.88% | $ 421,408,941,297 | 0.51% | 1.60% | 5.33% |
| 2003 | 0.51% | +0.03% | +0.34% | +0.16% | 2003 | 19.05% | +1.85% | +10.30% | +2.11% | $ 575,761,933,089 | 1.56% | 3.26% | 7.62% |
| 2004 | 0.89% | +0.08% | +0.49% | +0.30% | 2004 | 12.16% | +1.55% | +7.18% | +1.75% | $ 270,137,974,275 | 4.96% | 6.86% | 17.04% |
| 2005 | 1.70% | +0.14% | +0.90% | +0.44% | 2005 | 11.77% | +1.76% | +6.96% | +1.54% | $ 335,989,676,956 | 8.22% | 12.91% | 28.87% |
| 2006 | 2.61% | +0.26% | +1.47% | +0.58% | 2006 | 8.93% | +1.39% | +5.22% | +1.20% | $ 296,611,100,531 | 18.71% | 28.22% | 47.99% |
| 2007 | 2.14% | +0.18% | +1.39% | +0.44% | 2007 | 8.93% | +1.32% | +5.81% | +1.03% | $ 325,728,814,841 | 13.36% | 23.91% | 42.43% |
| 2008 | 0.72% | +0.08% | +0.48% | +0.17% | 2008 | 14.78% | +1.93% | +9.99% | +1.19% | $ 239,936,748,440 | 4.09% | 4.83% | 14.45% |
| 2009 | 0.03% | +0.00% | +0.03% | +0.01% | 2009 | 28.36% | +2.92% | +17.68% | +1.19% | $ 312,916,373,669 | 0.05% | 0.14% | 0.68% |

# SECTION 4b. THE EFFECT OF TIGHTENING INDIVIDUAL REQUIREMENTS

## ALL LOANS

| | Change in the Ever-90-Day Delinquency Rates After Decreasing Each Requirement | | | | Change in the Total QRM Dollar Volume After Decreasing Each Requirement | | | | | | Percent Change of Delinquency Rate to Mortgage Volume | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | QRM Delinquency Rate | Lower DTI | Lower LTV | Higher FICO | Year | QRM Volume | Lower DTI | Lower LTV | Higher FICO | All Loans | Lower DTI | Lower LTV | Higher FICO |
| 1997 | 0.42% | -0.03% | -0.10% | -0.10% | 1997 | 20.44% | -2.80% | -11.98% | -4.08% | $ 286,497,878,371 | 0.90% | 0.83% | 2.50% |
| 1998 | 0.39% | -0.02% | -0.10% | -0.10% | 1998 | 23.29% | -2.55% | -12.42% | -4.44% | $ 691,033,994,510 | 0.73% | 0.78% | 2.25% |
| 1999 | 0.44% | -0.02% | -0.10% | -0.12% | 1999 | 19.48% | -2.35% | -11.08% | -3.72% | $ 481,450,519,437 | 0.81% | 0.90% | 3.29% |
| 2000 | 0.32% | -0.01% | -0.08% | -0.09% | 2000 | 16.44% | -2.40% | -10.21% | -2.93% | $ 356,779,731,419 | 0.59% | 0.80% | 2.96% |
| 2001 | 0.31% | -0.01% | -0.08% | -0.07% | 2001 | 19.37% | -2.17% | -9.43% | -3.26% | $ 1,039,412,013,402 | 0.58% | 0.86% | 2.12% |
| 2002 | 0.33% | -0.01% | -0.10% | -0.07% | 2002 | 22.37% | -2.30% | -9.17% | -3.52% | $ 1,385,056,256,237 | 0.63% | 1.05% | 2.06% |
| 2003 | 0.55% | -0.03% | -0.18% | -0.13% | 2003 | 24.57% | -2.34% | -9.40% | -3.65% | $ 1,924,265,340,603 | 1.36% | 1.92% | 3.67% |
| 2004 | 0.95% | -0.07% | -0.38% | -0.22% | 2004 | 17.03% | -2.14% | -8.06% | -2.84% | $ 937,643,914,292 | 3.14% | 4.69% | 7.89% |
| 2005 | 1.86% | -0.17% | -0.84% | -0.42% | 2005 | 14.41% | -2.15% | -7.28% | -2.30% | $ 939,069,358,458 | 8.05% | 11.53% | 18.26% |
| 2006 | 2.72% | -0.25% | -1.35% | -0.59% | 2006 | 11.52% | -1.86% | -6.29% | -1.88% | $ 887,443,942,463 | 13.27% | 21.48% | 31.58% |
| 2007 | 2.37% | -0.23% | -1.18% | -0.59% | 2007 | 10.72% | -1.68% | -5.78% | -1.60% | $ 1,027,460,511,244 | 13.48% | 20.47% | 36.73% |
| 2008 | 0.68% | -0.06% | -0.24% | -0.17% | 2008 | 17.39% | -2.42% | -8.00% | -1.98% | $ 793,136,249,488 | 2.41% | 3.04% | 8.52% |
| 2009 | 0.04% | -0.00% | -0.01% | -0.01% | 2009 | 30.52% | -3.35% | -11.57% | -2.54% | $ 1,176,445,135,544 | 0.13% | 0.09% | 0.40% |

## PURCHASES

| Year | QRM Delinquency Rate | Lower DTI | Lower LTV | Higher FICO | Year | QRM Volume | Lower DTI | Lower LTV | Higher FICO | All Loans | Lower DTI | Lower LTV | Higher FICO |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1997 | 0.42% | -0.03% | -0.12% | -0.10% | 1997 | 20.74% | -3.10% | -14.07% | -3.99% | $ 171,316,168,315 | 0.88% | 0.85% | 2.45% |
| 1998 | 0.46% | -0.02% | -0.15% | -0.11% | 1998 | 22.08% | -2.93% | -15.60% | -4.28% | $ 243,827,154,269 | 0.70% | 0.95% | 2.65% |
| 1999 | 0.40% | -0.02% | -0.13% | -0.11% | 1999 | 19.86% | -2.76% | -13.88% | -3.66% | $ 252,736,885,537 | 0.66% | 0.96% | 2.93% |
| 2000 | 0.29% | -0.01% | -0.11% | -0.07% | 2000 | 18.17% | -2.77% | -12.45% | -3.16% | $ 259,462,348,244 | 0.46% | 0.89% | 2.27% |
| 2001 | 0.38% | -0.01% | -0.15% | -0.08% | 2001 | 19.57% | -2.74% | -13.89% | -3.48% | $ 334,671,388,428 | 0.48% | 1.11% | 2.29% |
| 2002 | 0.48% | -0.02% | -0.21% | -0.10% | 2002 | 18.43% | -2.58% | -13.15% | -3.27% | $ 378,648,800,742 | 0.67% | 1.62% | 3.12% |
| 2003 | 0.93% | -0.06% | -0.46% | -0.20% | 2003 | 18.03% | -2.50% | -13.00% | -2.95% | $ 428,404,858,343 | 2.48% | 3.53% | 6.69% |
| 2004 | 1.16% | -0.08% | -0.65% | -0.25% | 2004 | 16.71% | -2.52% | -11.69% | -2.78% | $ 397,943,548,817 | 3.15% | 5.57% | 9.11% |
| 2005 | 2.13% | -0.18% | -1.34% | -0.44% | 2005 | 15.67% | -2.57% | -10.86% | -2.41% | $ 433,917,427,309 | 7.15% | 12.39% | 18.32% |
| 2006 | 2.76% | -0.25% | -1.98% | -0.60% | 2006 | 13.57% | -2.32% | -9.51% | -2.11% | $ 459,040,004,449 | 10.63% | 20.78% | 28.40% |
| 2007 | 2.33% | -0.21% | -1.72% | -0.57% | 2007 | 12.39% | -2.08% | -8.72% | -1.77% | $ 504,879,485,501 | 9.85% | 19.76% | 32.34% |
| 2008 | 0.64% | -0.04% | -0.26% | -0.15% | 2008 | 17.33% | -2.72% | -11.43% | -1.96% | $ 321,485,446,506 | 1.65% | 2.27% | 7.66% |
| 2009 | 0.07% | -0.01% | -0.03% | -0.02% | 2009 | 27.06% | -3.95% | -19.57% | -2.61% | $ 225,983,942,702 | 0.13% | 0.15% | 0.79% |

## NO CASHOUT REFINANCES

Change in the Ever-90-Day Delinquency Rates After Decreasing Each Requirement

| Year | QRM Delinquency Rate | Lower DTI | Lower LTV | Higher FICO |
|---|---|---|---|---|
| 1997 | 0.37% | -0.02% | -0.09% | -0.10% |
| 1998 | 0.33% | -0.01% | -0.08% | -0.09% |
| 1999 | 0.46% | -0.02% | -0.13% | -0.14% |
| 2000 | 0.40% | -0.03% | -0.11% | -0.12% |
| 2001 | 0.27% | -0.01% | -0.06% | -0.06% |
| 2002 | 0.28% | -0.01% | -0.06% | -0.06% |
| 2003 | 0.46% | -0.02% | -0.12% | -0.12% |
| 2004 | 0.77% | -0.04% | -0.20% | -0.20% |
| 2005 | 1.43% | -0.13% | -0.40% | -0.40% |
| 2006 | 2.74% | -0.30% | -1.03% | -0.79% |
| 2007 | 2.86% | -0.31% | -1.22% | -0.84% |
| 2008 | 0.70% | -0.07% | -0.28% | -0.19% |
| 2009 | 0.04% | -0.00% | -0.01% | -0.01% |

Change in the Total QRM Dollar Volume After Decreasing Each Requirement

| Year | QRM Volume | Lower DTI | Lower LTV | Higher FICO | All Loans |
|---|---|---|---|---|---|
| 1997 | 21.04% | -2.48% | -10.09% | -4.33% | $ 72,883,400,278 |
| 1998 | 25.24% | -2.44% | -11.90% | -4.68% | $ 302,723,323,316 |
| 1999 | 20.34% | -1.97% | -9.08% | -3.98% | $ 140,480,199,805 |
| 2000 | 13.66% | -1.67% | -5.28% | -2.60% | $ 48,878,241,470 |
| 2001 | 22.56% | -2.11% | -8.74% | -3.55% | $ 390,566,245,688 |
| 2002 | 28.69% | -2.47% | -9.17% | -4.19% | $ 584,998,514,198 |
| 2003 | 31.06% | -2.49% | -9.79% | -4.31% | $ 920,098,549,171 |
| 2004 | 22.37% | -2.14% | -6.90% | -3.56% | $ 269,562,391,200 |
| 2005 | 16.42% | -1.87% | -5.28% | -2.61% | $ 169,162,254,193 |
| 2006 | 10.24% | -1.41% | -3.28% | -1.77% | $ 131,792,837,483 |
| 2007 | 9.41% | -1.28% | -3.15% | -1.50% | $ 196,852,210,902 |
| 2008 | 20.16% | -2.47% | -6.65% | -2.13% | $ 231,714,054,542 |
| 2009 | 32.80% | -3.27% | -10.63% | -2.54% | $ 637,544,819,173 |

Percent Change of Delinquency Rate to Mortgage Volume

| Lower DTI | Lower LTV | Higher FICO |
|---|---|---|
| 0.81% | 0.85% | 2.37% |
| 0.53% | 0.63% | 1.87% |
| 0.78% | 1.38% | 3.48% |
| 1.71% | 2.17% | 4.75% |
| 0.47% | 0.68% | 1.67% |
| 0.43% | 0.65% | 1.40% |
| 0.81% | 1.18% | 2.70% |
| 1.79% | 2.87% | 5.67% |
| 7.11% | 7.49% | 15.23% |
| 21.60% | 31.52% | 44.64% |
| 24.06% | 38.84% | 56.03% |
| 2.64% | 4.27% | 8.97% |
| 0.12% | 0.07% | 0.29% |

## CASHOUT REFINANCES

Change in the Ever-90-Day Delinquency Rates After Decreasing Each Requirement

| Year | QRM Delinquency Rate | Lower DTI | Lower LTV | Higher FICO |
|---|---|---|---|---|
| 1997 | 0.51% | -0.03% | -0.09% | -0.12% |
| 1998 | 0.39% | -0.02% | -0.06% | -0.10% |
| 1999 | 0.52% | -0.03% | -0.07% | -0.14% |
| 2000 | 0.51% | -0.02% | -0.05% | -0.18% |
| 2001 | 0.31% | -0.01% | -0.03% | -0.07% |
| 2002 | 0.31% | -0.01% | -0.05% | -0.07% |
| 2003 | 0.51% | -0.03% | -0.11% | -0.13% |
| 2004 | 0.89% | -0.07% | -0.23% | -0.21% |
| 2005 | 1.70% | -0.16% | -0.51% | -0.40% |
| 2006 | 2.61% | -0.22% | -0.83% | -0.48% |
| 2007 | 2.14% | -0.22% | -0.69% | -0.46% |
| 2008 | 0.72% | -0.07% | -0.21% | -0.17% |
| 2009 | 0.03% | -0.00% | -0.00% | -0.01% |

Change in the Total QRM Dollar Volume After Decreasing Each Requirement

| Year | QRM Volume | Lower DTI | Lower LTV | Higher FICO | All Loans |
|---|---|---|---|---|---|
| 1997 | 18.17% | -2.17% | -6.74% | -3.97% | $ 42,298,309,778 |
| 1998 | 21.25% | -2.11% | -8.12% | -4.19% | $ 144,483,516,926 |
| 1999 | 17.05% | -1.77% | -6.23% | -3.47% | $ 88,233,434,095 |
| 2000 | 10.03% | -1.19% | -3.19% | -2.05% | $ 48,439,141,706 |
| 2001 | 15.19% | -1.63% | -5.52% | -2.65% | $ 314,174,379,286 |
| 2002 | 17.13% | -1.80% | -5.58% | -2.83% | $ 421,408,941,297 |
| 2003 | 19.05% | -1.99% | -6.10% | -3.12% | $ 575,761,933,089 |
| 2004 | 12.16% | -1.58% | -3.89% | -2.23% | $ 270,137,974,275 |
| 2005 | 11.77% | -1.74% | -3.66% | -2.01% | $ 335,989,676,956 |
| 2006 | 8.93% | -1.36% | -2.63% | -1.56% | $ 296,611,100,531 |
| 2007 | 8.93% | -1.30% | -2.80% | -1.40% | $ 325,728,814,841 |
| 2008 | 14.78% | -1.95% | -4.70% | -1.87% | $ 239,936,748,440 |
| 2009 | 28.36% | -3.10% | -7.72% | -2.50% | $ 312,916,373,669 |

Percent Change of Delinquency Rate to Mortgage Volume

| Lower DTI | Lower LTV | Higher FICO |
|---|---|---|
| 1.23% | 1.30% | 3.00% |
| 1.18% | 0.68% | 2.49% |
| 1.91% | 1.08% | 4.05% |
| 1.55% | 1.66% | 8.72% |
| 0.73% | 0.47% | 2.68% |
| 0.73% | 0.93% | 2.58% |
| 1.33% | 1.80% | 4.16% |
| 4.75% | 5.99% | 9.28% |
| 9.36% | 13.81% | 20.13% |
| 16.00% | 31.46% | 30.57% |
| 17.30% | 24.67% | 32.91% |
| 3.64% | 4.49% | 8.98% |
| 0.15% | 0.01% | 0.38% |

# SECTION 4c: THE MARGINAL EVER-90-DAY DELINQUENCY RATES THAT RESULT FROM ADJUSTMENTS TO INDIVIDUAL REQUIREMENTS

The Ever-90-Day Delinquency Rate for Mortgages That Would Have Gained QRM Qualification from Relaxing an Individual Requirement

| | ALL LOANS | | | | PURCHASE LOANS | | | | NO CASHOUT REFINANCES | | | | CASHOUT REFINANCES | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | QRM Delinquency Rate | Higher DTI | Higher LTV | Lower FICO | QRM Delinquency Rate | Higher DTI | Higher LTV | Lower FICO | QRM Delinquency Rate | Higher DTI | Higher LTV | Lower FICO | QRM Delinquency Rate | Higher DTI | Higher LTV | Lower FICO |
| 1997 | 0.42% | 0.70% | 0.79% | 1.71% | 0.42% | 0.67% | 0.85% | 1.70% | 0.37% | 0.71% | 0.55% | 1.59% | 0.51% | 0.84% | 1.04% | 1.95% |
| 1998 | 0.39% | 0.55% | 0.72% | 1.62% | 0.46% | 0.59% | 0.99% | 1.87% | 0.33% | 0.46% | 0.58% | 1.46% | 0.39% | 0.68% | 0.81% | 1.55% |
| 1999 | 0.44% | 0.60% | 0.98% | 2.05% | 0.40% | 0.51% | 0.98% | 1.94% | 0.46% | 0.69% | 0.92% | 2.15% | 0.52% | 0.86% | 1.04% | 2.14% |
| 2000 | 0.32% | 0.34% | 0.85% | 1.42% | 0.29% | 0.29% | 0.71% | 1.29% | 0.40% | 0.50% | 0.81% | 1.50% | 0.51% | 0.72% | 1.15% | 2.19% |
| 2001 | 0.31% | 0.47% | 0.66% | 1.34% | 0.38% | 0.53% | 0.96% | 1.62% | 0.27% | 0.42% | 0.57% | 1.16% | 0.31% | 0.44% | 0.68% | 1.26% |
| 2002 | 0.33% | 0.50% | 0.80% | 1.40% | 0.48% | 0.65% | 1.17% | 1.70% | 0.28% | 0.43% | 0.75% | 1.27% | 0.31% | 0.41% | 0.78% | 1.33% |
| 2003 | 0.55% | 0.99% | 1.34% | 2.30% | 0.93% | 1.50% | 2.03% | 3.31% | 0.46% | 0.81% | 1.19% | 2.05% | 0.51% | 0.84% | 1.47% | 2.12% |
| 2004 | 0.95% | 1.72% | 2.09% | 3.41% | 1.16% | 1.94% | 2.66% | 3.79% | 0.77% | 1.45% | 1.84% | 3.10% | 0.89% | 1.57% | 2.21% | 3.26% |
| 2005 | 1.86% | 3.15% | 3.87% | 5.79% | 2.13% | 3.41% | 4.48% | 6.09% | 1.43% | 2.86% | 3.20% | 5.54% | 1.70% | 2.81% | 4.12% | 5.54% |
| 2006 | 2.72% | 4.68% | 6.35% | 7.72% | 2.76% | 4.61% | 5.51% | 7.70% | 2.74% | 5.32% | 6.22% | 8.34% | 2.61% | 4.54% | 6.60% | 7.47% |
| 2007 | 2.37% | 4.08% | 6.06% | 7.32% | 2.33% | 3.93% | 4.76% | 6.94% | 2.86% | 5.67% | 7.51% | 9.98% | 2.14% | 3.51% | 5.66% | 6.36% |
| 2008 | 0.68% | 1.32% | 1.98% | 3.31% | 0.64% | 1.15% | 2.48% | 3.44% | 0.70% | 1.53% | 1.78% | 3.42% | 0.72% | 1.41% | 1.92% | 3.03% |
| 2009 | 0.04% | 0.09% | 0.10% | 0.32% | 0.07% | 0.12% | 0.14% | 0.48% | 0.04% | 0.09% | 0.09% | 0.30% | 0.03% | 0.05% | 0.10% | 0.23% |

The Ever-90-Day Delinquency Rate for Mortgages That Would Have Lost QRM Qualification from Tightening an Individual Requirement

| | ALL LOANS | | | | PURCHASE LOANS | | | | NO CASHOUT REFINANCES | | | | CASHOUT REFINANCES | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | QRM Delinquency Rate | Lower DTI | Lower LTV | Higher FICO | QRM Delinquency Rate | Higher DTI | Higher LTV | Lower FICO | QRM Delinquency Rate | Lower DTI | Lower LTV | Higher FICO | QRM Delinquency Rate | Lower DTI | Lower LTV | Higher FICO |
| 1997 | 0.42% | 0.58% | 0.49% | 0.83% | 0.42% | 0.58% | 0.48% | 0.83% | 0.37% | 0.52% | 0.46% | 0.76% | 0.51% | 0.71% | 0.66% | 0.94% |
| 1998 | 0.39% | 0.54% | 0.47% | 0.81% | 0.46% | 0.59% | 0.52% | 0.93% | 0.33% | 0.45% | 0.41% | 0.72% | 0.39% | 0.62% | 0.48% | 0.82% |
| 1999 | 0.44% | 0.57% | 0.51% | 0.96% | 0.40% | 0.51% | 0.45% | 0.87% | 0.46% | 0.60% | 0.62% | 1.03% | 0.52% | 0.81% | 0.63% | 1.06% |
| 2000 | 0.32% | 0.41% | 0.37% | 0.72% | 0.29% | 0.36% | 0.34% | 0.63% | 0.40% | 0.60% | 0.58% | 0.93% | 0.51% | 0.64% | 0.62% | 1.20% |
| 2001 | 0.31% | 0.41% | 0.40% | 0.66% | 0.38% | 0.46% | 0.45% | 0.75% | 0.27% | 0.36% | 0.36% | 0.58% | 0.31% | 0.41% | 0.36% | 0.65% |
| 2002 | 0.33% | 0.46% | 0.47% | 0.72% | 0.48% | 0.58% | 0.56% | 0.95% | 0.28% | 0.39% | 0.41% | 0.62% | 0.31% | 0.42% | 0.42% | 0.68% |
| 2003 | 0.55% | 0.85% | 0.84% | 1.32% | 0.93% | 1.32% | 1.11% | 1.94% | 0.46% | 0.69% | 0.71% | 1.18% | 0.51% | 0.74% | 0.74% | 1.17% |
| 2004 | 0.95% | 1.42% | 1.38% | 2.07% | 1.16% | 1.61% | 1.44% | 2.43% | 0.77% | 1.13% | 1.21% | 1.83% | 0.89% | 1.39% | 1.38% | 1.81% |
| 2005 | 1.86% | 2.85% | 2.69% | 4.07% | 2.13% | 3.07% | 2.73% | 4.56% | 1.43% | 2.47% | 2.27% | 3.53% | 1.70% | 2.64% | 2.82% | 3.67% |
| 2006 | 2.72% | 4.00% | 3.84% | 5.76% | 2.76% | 3.95% | 3.60% | 6.01% | 2.74% | 4.65% | 4.94% | 6.52% | 2.61% | 3.82% | 4.59% | 4.86% |
| 2007 | 2.37% | 3.59% | 3.38% | 5.72% | 2.33% | 3.35% | 3.06% | 5.77% | 2.86% | 4.81% | 5.29% | 7.29% | 2.14% | 3.46% | 3.65% | 4.61% |
| 2008 | 0.68% | 1.04% | 0.96% | 1.99% | 0.64% | 0.88% | 0.77% | 1.81% | 0.70% | 1.16% | 1.27% | 2.31% | 0.72% | 1.19% | 1.18% | 1.88% |
| 2009 | 0.04% | 0.08% | 0.06% | 0.15% | 0.07% | 0.10% | 0.08% | 0.26% | 0.04% | 0.07% | 0.05% | 0.12% | 0.03% | 0.07% | 0.04% | 0.13% |




U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410

**Written Testimony of Bob Ryan**
**Acting Assistant Secretary for Housing and FHA Commissioner**
**U.S. Department of Housing and Urban Development (HUD)**

**Hearing before the House Financial Services Committee**
**Subcommittee on Capital Markets and Government Sponsored Entities**
**on**

**Understanding the Implications and Consequences of the Proposed Rule on Risk Retention**

**Thursday April 14, 2011**

Chairman Garrett, Ranking Member Waters, and other distinguished Members of the Subcommittee, thank you for the opportunity to testify today on the implications and consequences of the proposed rule on risk retention. My name is Bob Ryan and I am the Acting Assistant Secretary for Housing and Acting Commissioner of the Federal Housing Administration (FHA) at the U.S. Department of Housing and Urban Development. In my former role as Deputy Assistant Secretary for Risk Management and Regulatory Affairs and FHA's Chief Risk Officer, I oversaw FHA's enterprise risk management functions in a division encompassing all of its business lines, including single family, multifamily and healthcare. Combined with nearly three decades within the private sector in all aspects of the mortgage market, my experience gives me a deep understanding of the mortgage origination and capital markets processes and the government's role within them.

I am here today to discuss the Qualified Residential Mortgage (QRM), as defined in the recently issued Notice of Proposed Rulemaking on risk retention, in the context of the FHA's current and on-going role in the housing market.

As this Committee is aware, HUD is one of six agencies participating in the risk retention rulemaking process. These agencies were specified by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which sets forth the parameters of that process.

The goal of the proposed risk retention rule is to provide clarity and offer "rules of the road" to the securitization markets. The proposed rule is one part of the Administration's goal of bringing private capital back into the housing finance system. Getting this right is critical. With the

financial crisis, we saw how bundling and packaging mortgages to sell on Wall Street with no accountability helped lead to the erosion of lending and underwriting standards that fed the housing boom and deepened the housing bust. Dodd-Frank specifically requires that securitizers or originators have 'skin in the game' by retaining at least 5 percent of the credit risk and the proposed rule sets out a variety of options to accomplish that mandate.

The proposed rule also seeks to define a QRM -- a loan that would not be subject to the risk retention requirements as provided by Dodd-Frank. Let me be clear: we fully support requiring more "skin-in-the-game" requirements as well as underwriting standards, including full documentation, both of which the proposed QRM definition addresses. We believe in fostering loan products that allow borrowers to prudently manage risk, support their monthly payments and succeed in obtaining sustainable homeownership.

The crisis has highlighted the importance of strong underwriting standards and the need for heightened due diligence on the "3 C's" of lending: credit, collateral and capacity. In other words, a lender needs to truly assess a borrower's capacity to repay a loan, a buyer's credit experience, the value of the property being financed, and the type of mortgage. More specifically, for credit, that means fully understanding the borrower's credit history and scanning for foreclosures, bankruptcies, liens and/or judgments, mortgage delinquencies, credit delinquencies, repossessions, collections, or charge-offs. It means verifying credit accounts, their type, age, limits, usage and the status of revolving accounts. For collateral, it means an accurate and objective appraisal of the property and assessing the down payment structure. For capacity, it means verifying monthly housing expense-to-income ratio or monthly debt payment-to-income ratio, confirming employment and income, identifying cash reserves and weighing that against the characteristics and purpose of the loan type considered. In this manner, a lender can properly identify responsible borrowers that can achieve sustainable mortgages.

Strong underwriting has been at the core of FHA's success. Because FHA insures lenders against losses that may result in the event of a borrower default, that commitment is made under the condition that lenders are required to abide by extensive documentation and underwriting guidelines to originate sustainable mortgages. Lenders are also required to provide loss mitigation opportunities to help borrowers avoid default or foreclosure. Steps taken to hone our underwriting standards in the past year have allowed FHA to materially strengthen its balance sheet and to further strengthen its capital reserves. I would also like to add that, pursuant to the specific provisions of Dodd-Frank, loans insured by FHA are exempt from the risk retention requirements.

Given the exigencies of strong underwriting for healthy, sustainable mortgages, we must be mindful of the trade-off presented by the current definition of QRM between improvement in loan quality and affordability and accessibility for prospective homebuyers. In other words, how much lift to performance do we get to the exclusion of creditworthy borrowers with a tighter band? While QRM is designed to create a class of loans that have a lower likelihood of default,

in its proposed definition it has the potential to exclude a number of buyers. Stated another way, this definition has the potential to create false positive situations that deny creditworthy borrowers affordable loans in this class. This potential situation then begs one of the questions for which we actively seek comment: what costs will borrowers allocated to the non-QRM bucket have to face? In turn, what impact will this bifurcated mortgage market have on liquidity? Again, we look forward to receiving feedback on this issue. By answering these challenging questions, we can better fashion a system that strikes the right balance between strong underwriting and ensuring all creditworthy borrowers have access to affordable products.

On a more granular level, QRM status is determined by a number of factors, including product type, Payment-to-Income (PTI)/Debt-to-Income (DTI) ratios, Loan-to-Value ratio (LTV) and delinquency history, as defined within the proposed rule. Not surprisingly, much of the debate has focused on the appropriate LTV ratio that should be required in the rule. While there is no question that larger down payments correlate with better loan performance, down payments only tell part of the story. That is why the proposed rule includes an alternative definition that considers a 10% higher LTV with the inclusion of credit enhancement that duly incorporates strong underwriting requirements and servicing standards.

In addition to LTV, we must also focus on the other QRM requirements. FHA uses both downpayment and FICO scores to allocate credit assistance, which, together, we have found to be a much better predictor of loan performance than just one of those components alone. For instance, FHA insured loans with LTV above 95% and a FICO score above 580 perform better than loans with LTV below 95% and a FICO score below 580, while loans with a LTV above 95% and a FICO score below 580 perform significantly worse than all other groups, as illustrated below.

**FHA Single Family Insured Loan Claim Rates**
**Relative Experience by Loan-to-Value and Credit Score Values[1]**

**Ratios of Each Combination's Claim Rate**
**to that of the Lowest Risk Cell[2]**

[1] Based on experience of the FY 2005 – FY 2008 insurance cohorts, as of February 28, 2010. These ratios represent averages of the cell-level ratios in each cohort.
[2] Claim rates in the first row and last column are the low-risk cell and are represented by a ratio value of 1.00. Values in all other cells of this table are ratios of the cell-level claim rate to the claim rate of the low-risk group.

| Loan-to-Value Ratio Ranges | Credit Score Ranges[3] | | | |
|---|---|---|---|---|
| | 500-579 | 580-619 | 620-679 | 680-850 |
| Up to 90% | 2.6 | 2.5 | 1.9 | 1.0 |
| 90.1 - 95% | 5.9 | 4.7 | 3.8 | 1.7 |
| Above 95% | 8.2 | 5.6 | 3.5 | 1.5 |

Source: US Department of HUD/FHA; March 2010

Moreover, our two-step FICO floor scales the level of down payment required based on the borrower's score with 3.5% required for a score above 580 and 10% if between 500 and 579. The point here is that not only is it necessary to give FHA the flexibility necessary to respond to market conditions and manage risk, but also that a number of factors can predict or impact loan performance – as identified in the overall QRM proposal – and downpayment level alone cannot be seen as exclusively predictive of loan performance. To that end, we seek comment on the impacts of each of the QRM criteria. In addition to FHA, Fannie Mae and Freddie Mac have a long history of providing loans with 10% down payment with the use of mortgage insurance that have exhibited strong performance.

To quote my predecessor, David Stevens, "we have a responsibility to continue our work fixing the fundamental flaws in the mortgage market to help restore confidence among homeowners, lenders, and investors." Defining QRM in this joint rule making effort is indeed a step forward in that reform process But we cannot rest. Now rule makers should strive to ensure that it supports a liquid and robust marketplace and the return of responsible private capital based on prudent risk retention that will make the market sturdier. To do so, we must flesh out all the issues QRM presents.

We have been pleased to participate in this inter-agency effort and have posed many questions in the proposed rule on which we are eager to receive feedback. I want to emphasize that no final decisions have been reached and we look forward to reviewing and considering all the comments that are received. We also remain committed to open dialogue with the Committee and look forward to engaging with a wide range of stakeholders to understand their concerns so that we strike the right balance between managing risk and maintaining access to safe, responsible homeownership.

[3] Loan-level scores represent the decision FICO scores used for loan underwriting. This analysis includes all fully-underwritten loans, purchase and refinance, but excludes streamline refinance loans.

**STATEMENT OF KEVIN SCHNEIDER BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES**
**April 14, 2011**

I am Kevin Schneider, President and Chief Executive Officer, U.S. Mortgage Insurance of Genworth Financial in Raleigh, North Carolina. I also am President of the Mortgage Insurance Companies of America (MICA), the trade association representing the mortgage insurance industry. I am pleased to be here today to discuss the risk retention provision of the Dodd – Frank Act. Since mortgage insurers' sole business is insuring mortgages with low down payments, I will confine my testimony to the definition of a Qualified Residential Mortgage (QRM) recently proposed by six regulators.

MICA is very concerned that the definition of QRM did not include loans with less than a twenty percent down payment that are privately insured and believes that these loans should be included in the QRM definition. We do not believe affordability and sustainability are mutually exclusive goals. Mortgage insurers enable home-ready borrowers to safely buy homes with less than a 20% down payment. We understand the drivers of sustainable, affordable homeownership because our industry has a vested interest in making certain that homebuyers are given mortgages they can afford to pay over the long term. If the loan is not sustainable, the capital of a mortgage insurance firm is at risk because it must pay a claim if the loan goes to foreclosure.

The proposed rule exempts loans sold to the GSEs from the risk retention requirements while they are in conservatorship because they carry an effective federal guarantee during this time. MICA realizes that many members of the subcommittee question that exemption and we understand their wish to both improve originations and minimize the role of the federal government. However, MICA supports that exemption because it maintains the status quo in the mortgage market until Congress deliberates over how to reform and revamp the secondary market as well as determine the future of FHA. Without that exemption the primary source of private sector capital in the market today – private mortgage insurance (MI) -- could be marginalized to the extent that it's no longer serving the market to its full capacity. As we discuss below this could impede the ability to return private sector capital to the market by driving virtually all low-down payment loans to FHA. Finally, maintaining the exception for GSE loans also insures that private mortgage insurance stands in front of the taxpayers if a low-down payment loan goes to default.

In this testimony, I will address the proposed definition as if the GSE exemption were not included. I will discuss the important role MI plays in the market and its regulatory structure. I will then discuss the reasons privately insured loans should be included in the QRM definition and be given parity with FHA-insured loans. The reasons include the following:

- Without the inclusion of privately insured loans in the QRM definition, credit-worthy, lower income and first-time homebuyers will have fewer or more expensive options to finance their home and could be locked out of the housing market altogether.

- Fewer options for prudent, low-down payment loans also will impede the housing recovery.
- To return private sector capital to the market, privately insured loans must be included in the QRM definition because risk retention requirements will drive low-down payment lending to the government programs that are exempt.
- Potential taxpayer liability for FHA-insured loans already is projected to reach more than $1 trillion and could climb further if privately insured loans are not put on an equal footing.
- Privately insured loans meet the requirements set for them in Dodd-Frank because private mortgage insurance reduces the risk of default.

**The Role of MI**

The primary barrier for most borrowers to buying a home is coming up with a 20% down payment. That barrier can be overcome in a safe and sound manner by encouraging the use of private mortgage insurance. MI enables borrowers to buy homes with less than a 20% down payment because MI takes the first loss after the borrower, if the borrower defaults. When the loan goes to foreclosure, the MI coverage typically pays the investor 20% to 25% of the loan amount.

Because mortgage insurers are in the first loss position on the mortgages we insure, our interests are aligned with those of both the borrower and the mortgage investor, thus ensuring better quality mortgages. Mortgage insurers act as a second set of eyes by reviewing the credit and collateral risks related to individual loans. This role protects both borrowers and investors by ensuring that the home is affordable at the time of purchase and throughout the years of homeownership.

The Regulatory Strength of MI

MI is a regulated, counter-cyclical source of loan level protection provided for a mortgage loan, based on independent, objective underwriting criteria. It is for this reason that global regulators have repeatedly reviewed and, then, confirmed the value of properly-regulated and appropriately capitalized private mortgage insurance. In January of 2010,[1] the Joint Forum urged member nations to ensure that greater use of MI is part of their mortgage-reform efforts. The Joint Forum is an advisory committee comprised of global banking, securities and insurance regulators. In addition to urging greater reliance on MI, the Joint Forum paper described the need to ensure that capital credit and regulatory recognition is provided only when private MI is in fact well regulated and capitalized, noting the significant problems that result from reliance on products such as credit derivatives.

[1] The Joint Forum, *Review of the Differentiated Nature and Scope of Financial Regulation - Key Issues and Recommendations,* (Jan. 8, 2010), *available at* http://www.bis.org/publ/joint24.pdf.

The Joint Forum's advisory work has since been advanced as a firm recommendation from the Financial Stability Board[2] (FSB), the governing body for all global financial regulators (including those in the U.S.). In its final paper detailing recommendations for mortgage underwriting, the FSB concludes that, "Mortgage insurance can be relevant for the reduction of uncertainty through risk selection and pricing, a prudent application which includes an in-depth assessment of mortgage insurance reliability. The recent crisis has shown how deceptive risk transfer mechanisms can be."[3]

The backbone of the private mortgage insurance industry's financial strength is its state-imposed reserve requirements. The reserve requirements were developed in a model MI act that was established by the National Association of Insurance Commissioners (NAIC) and is primarily enforced by the states where MI companies are domiciled. The requirements are specifically structured to address the long-term nature of MI risk. They enable the industry to withstand a sustained period of heavy defaults arising from serious regional or national economic downturns, as well as routine defaults and claims that occur normally throughout the cycle.

Mortgage insurers are required to keep three types of reserves, the most important of which is the contingency reserve. Fifty cents of each premium dollar earned goes into the contingency reserve and generally cannot be touched by the mortgage insurer for a 10-year period. It ensures that significant reserves are accumulated during good times not only to handle claims under stress, but also to avoid boom-bust cycles. The contingency reserves are directly comparable to the counter-cyclical capital bank regulators now know they need. Mortgage insurers are subject to similar mortgage default risk as banks but only mortgage insurers raise capital counter-cyclically.

Chart 1 demonstrates how the MI industry builds its capital base during good times to pay claims in bad times like those currently experienced by the housing market. The chart shows yearly industry losses paid as a percentage of premiums earned for each year from 1980 through the third quarter of 2010. It also shows the MI industry's risk to capital ratio for each year and the build-up of premiums available to pay claims over time. As can readily be seen, the fact that mortgage insurers do not earn all of the premiums they receive each year -- but are required to keep a portion of the premiums in a contingency reserve -- means that premiums available to pay claims increase during the good times so they can be paid out to cover the serious losses that occur during the bad times.

The other two reserves that mortgage insurers must maintain are case-basis loss reserves and unearned premium reserves. Case-basis loss reserves are established for losses on individual policies when the insurer is notified of defaults. Premiums received for the term of a policy are placed in unearned premium reserves. Each state establishes the method by which premiums are earned to match premiums with loss and exposure.

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[2] Financial Stability Board, *Thematic Review on Mortgage Underwriting and Origination Practices* (Mar. 17, 2011), *available at* http://www.financialstabilityboard.org/publications/r_110318a.pdf.

[3] Ibid, p. 25.

The history of the MI industry shows that we have paid our claims through good and bad economic cycles. For example, in the early 1980s, the mortgage market had to cope with double-digit interest rates and inflation in a period of severe recession and, therefore, introduced many experimental adjustable-rate mortgages. As economic conditions deteriorated -- particularly in energy-oriented regions of the country -- defaults began to rise, resulting in numerous foreclosures. The MI industry paid more than $6 billion in claims to its policyholders during the 1980s. In the early 1990s, the MI industry paid more than $8 billion in claims primarily in California and the Northeast.

The first loss position of MI makes it a valuable offset to mortgage credit risk. This benefit extends to lenders that hold loans in portfolio and in the case of Fannie Mae and Freddie Mac, to taxpayers who are otherwise exposed to GSE losses. Over the course of the current mortgage crisis, the MI industry estimates that it will pay around $30 billion in claims in front of the taxpayer to Fannie Mae and Freddie Mac. Indeed, since the current mortgage crisis began, Fannie Mae and Freddie Mac have received from mortgage insurers $22 billion in claim payments and receivables, equivalent to more than 14% of the amount U.S. taxpayers have had to spend to date on the GSEs during their conservatorship.

Not only does the MI industry have ample regulatory capital with the three types of reserves discussed above, but it also has been able to attract new capital to the industry. Since the mortgage crisis began, the industry has raised $8.8 billion through new capital and assets sales and investors have provided an additional $600 million to capitalize a new entrant to the industry. The recent capital inflows to the industry are strong indicators of investor confidence in the private mortgage insurance business model and regulatory construct.

It is not surprising that the credit risk mitigation tools that were often used prior to the crisis are no longer available. The capital and regulatory strength of the MI industry as well as its proven ability to withstand periods of heavy defaults, is in sharp contrast to other forms of external loan-level credit enhancements which are not regulated, not well capitalized, and have not demonstrated a capacity to satisfy their obligations and ensure prudent loan originations. In addition, many are not offered by a bona fide, third-party unrelated to the originator or securitizer. For example, credit default swaps (CDS) have been a source of profound systemic risk in the current crisis, and the regulatory framework required to correct this problem still must be constructed following the new standards in the Dodd-Frank Act. The Joint Forum paper cited above details an array of supervisory and capital problems in the CDS sector that have yet to be acted upon and reformed in the U.S. or global markets.

**Inclusion of MI in QRM is Essential for Credit-Worthy Homebuyers and the Housing Recovery**

Since 1957, the private mortgage insurance industry has helped more than 25 million families buy homes. The MI industry's insurance-in-force as of December 31, 2010 was $753 billion, or 7.1 percent of U.S. single family, first liens then outstanding. Since 2007, mortgage insurers have paid over $22 billion in claims.

Credit-Worthy Homebuyers Need Options

According to the 2009 Home Mortgage Disclosure Act (HMDA) data (the most recent data available), 37% of the borrowers who received mortgages insured by private mortgage insurers to purchase homes made less than area median income and 23% made less than 80% of area median income. We believe the primary users of MI to purchase homes are first-time homebuyers. This sector is crucial to the reduction in excess housing inventory which is essential to a full recovery in the housing market. A survey by the National Association of Realtors estimates that half of all purchases last year were by first-time homebuyers and that 86% of these buyers made down payments below 20%.

Without broad availability of affordable low-down payment loans, hard-working Americans will have to wait significantly longer before they are able to save enough to purchase their first home. For example, at a typical savings rate, it would take a family earning $50,000 a year, more than eleven years to save a 20% down payment on a $153,000 home (the median priced existing house sold in the U.S. in 2010).

QRM Should Not Impede the Housing Recovery

Today, wide availability of low-down payment loans also is necessary for the housing market recovery. As a result of the current housing downturn many families that bought during the market boom have lost equity in their current homes. People who bought homes in the past few years but now need to move for a new job or need a larger home for their family are at a disadvantage with a 20% minimum down payment requirement because they were not able to build equity as homeowners did in past years and may well have lost some or all of the equity they invested in their current home. These low down payment repeat and first-time homebuyers who need private, low-down payment options are a large part of today's housing market and are critical to a housing recovery. The National Association of Realtors estimates that 75% of all buyers – first-time buyers and repeat buyers – financed 80% or more of their home purchase in 2010.

Without the continued availability of adequate, prudent private capital options for low-down payment lending, both first-time and repeat homebuyers will have fewer attractive financing options. As a result, these potential home purchasers will delay or end their attempt to buy a house and, as a consequence, impede the housing market recovery.

Private Sector Capital Ready to Make Prudently Underwritten Mortgages Affordable

Today the MI industry is well positioned to help expand affordable housing opportunities in a responsible manner. However, including MI-insured loans in the QRM is essential to enabling the industry to put its private capital to work. Under strong capital rules from state insurance regulators, the MI industry has sufficient capital to increase their total insurance exposure by $261 billion a year for the next three calendar years. If this additional volume is realized it would mean that approximately 1.3 million additional mortgages would be insured in each of the next three years. Many of these new insured mortgages would go to lower income

and first-time homebuyers who do not have the necessary funds to make large down payments but still have adequate income and credit to enjoy long-term, sustainable homeownership through an insured mortgage.

**Without MI Loans Included in QRM, Low-Down payment Lending will be Pushed to FHA**

Requiring a 20% minimum down payment for all loans, unless they are insured by a federal agency such as the FHA, will seriously undermine efforts to bring private sector capital back into the housing market and may expose taxpayers to significant new risk. It is clear that regulators intend risk retention to be expensive and they have succeeded for bank securitizers. For bank mortgage securitizers, the proposed risk-retention requirements will be very costly. Both the current capital requirements[1] and Basel III,[2] impose significant risk-based capital requirements for the three options in the proposal. In fact, these requirements make the risk-retention position among the most capital-intensive positions for banks under both the current and new regulatory capital standards.

The added capital pressure of the risk retention rule will only exacerbate reductions in credit availability, which we believe could essentially shut down mortgage origination and securitization outside the QRM exception. Of course, the other alternative is to originate FHA-insured loans because they are completely exempt from the risk retention requirements and impose no extra cost on securitizers. As a result, if privately insured loans are not treated similarly to FHA-insured loans, lenders will direct homebuyers who cannot accumulate a 20% down payment to FHA.

Beyond the cost of risk retention, FHA offers 100% government insurance. In contrast, as noted earlier, private mortgage insurers generally cover 20% to 25% of the loan amount. In today's housing market with falling or stagnant home prices, this feature of privately insured loans generally means that lenders do have "skin in the game" because lenders often suffer a loss even after they receive the MI claim payment and the proceeds from the sale of the house.

FHA already is exposing taxpayers to significant potential liability. The fiscal year 2012 Administration budget projects that the FHA's insurance-in-force will increase 28% in this fiscal year (2011) and 10% in the next fiscal year. Taxpayer exposure for FHA mortgages will be $1.253 trillion by September 30, 2012. Not treating privately insured loans similarly to FHA-insured loans in the QRM could significantly increase that potential exposure.

**Mortgage Insurance Meets the QRM Standard – It Reduces Defaults**

MI's Incentive to Reduce Defaults

Section 941 of the Dodd-Frank Act recognized that risk retention can be a strong deterrent to excessive risk taking that led to the housing crisis. At the same time Dodd-Frank

[1] 12 C.F.R. § 3, Apps. A and C.

[2] Basel Committee on Banking Supervision (BCBS), *Basel III: A Global Regulatory Framework For More Resilient Banks And Banking Systems* (Dec. 16, 2010) *available at* http://www.bis.org/publ/bcbs189.htm.

acknowledged that risk retention should not apply to all mortgage loans because doing so would add unnecessary costs to loans and reduce liquidity. As a result it directed six agencies to jointly develop a definition of a QRM and gave them criteria to consider. One of those criteria was private mortgage insurance to the extent that it reduces defaults.

Private mortgage insurance meets that condition because, as noted above, it brings a second set of eyes to the mortgage origination process. It acts as a review underwriter of the risk factors in the mortgage application and makes an independent judgment as to whether the borrower can afford the home. Mortgage insurers have their own capital at risk, in the first loss position and, therefore, work up-front to ensure the borrower can afford the mortgage.

Having our own capital at risk also means that mortgage insurers have very clear incentives to mitigate their losses if loans are in default. The best way to do that, of course, is to avoid foreclosures altogether by working with borrowers to keep them in their homes. Mortgage insurers have a history of partnering with lenders, investors and community groups to work with borrowers in default. This often means that, with the servicers' permission, mortgage insurers counsel the borrowers personally and determine if their financial problems can be resolved. From 2008 through year-end 2010 mortgage insurers have completed almost 645,000 workouts covering $130 billion in mortgage loans.

Data Proves MI Reduces Defaults

Recent analysis of MI-insured mortgages versus piggyback mortgages brings to light the importance of private sector capital at risk in a first loss position.[4] Piggyback loans are loans where borrowers have little or no equity in their mortgages. Instead, borrowers get an 80% first mortgage loan and simultaneously get up to a 20% second mortgage. Therefore, the borrowers have little or no equity in their mortgage, but unlike low-down payment loans with private mortgage insurance, there is no private sector capital at risk in a first loss position.

An analysis using loan level data on 4.9 million loans originated between 2003 and 2007 compared delinquency, default and cure rates of loans with combined loan to value ratios (CLTV) of over 80% that were done as single first liens with mortgage insurance to over 80% CLTV loans that were structured as piggyback mortgages with an uninsured first lien coupled with a simultaneous second lien mortgage. Piggyback loans became delinquent or defaulted approximately 1.65 times more frequently than insured loans with the same characteristics including, CLTV, borrower credit scores, origination year, geographic location, loan purpose and borrower documentation levels. This analysis demonstrates that not all low down payment loans are the same. MI significantly mitigates the risk that a high LTV loan will become delinquent and go to default. The data makes it clear that with proper underwriting and mortgage insurance, low down payment lending can be done without exposing the borrower, lender or investor to excessive risk. A chart with a summary of the data is the first attachment.

[4] http://sec.gov/comments/df-title-ix/asset-backed-securities/assetbackedsecurities-6.pdf

MIs Raised Concerns Before the Mortgage Crisis and Will Continue to be a Vital Watchdog.

Because of its unique position in the market, the MI industry was the "canary in the coal mine" for the problems in the mortgage finance system long before the bank regulators and the rest of the industry recognized what was happening. The industry can and should continue to perform that function and, therefore, should be included in the QRM definition.

Beginning in 2002 the MI industry raised concerns with financial institution regulators about the underwriting of high-risk mortgage products and the regulatory and capital incentives that existed for the creation of these products. The industry's concern was derived from the economic interests of the industry, its position as the provider of first loss protection on first lien, residential mortgages and the industry's half century of experience in reviewing mortgage underwriting by lenders during good and bad economic times. The industry's initial concern was focused on the growing number of structured finance, or piggyback loans in the market that not only were higher risk loans because the borrower had little or no equity in the property, but – importantly – because there was no private sector capital at risk when the lenders avoided MI by using a piggyback structure.

MICA began to communicate with bank regulators on the problems the industry was seeing in the market in 2002. As MICA explained in a December 3, 2002 letter to the Federal Reserve, OCC, OTS and FDIC referring to the use of piggyback structures:

> MICA would remind the agencies that mortgages are a major source of risk to insured depositories. Despite the high quality of the collateral underlying first liens on residential mortgages, these loans were the underlying source of the S&L debacle during the 1980s because thrifts did not hold sufficient regulatory capital against the various risks these assets pose. Mortgages have since become still more risky because of the increasing role of high-LTV mortgages, at the same time that consumer debt-service burdens have reached unprecedented levels despite historic low interest rates. A failure to impose appropriate regulatory capital for the riskiest type of mortgage asset – structured seconds – could expose the nation's financial system to significant risk as interest rates rise, housing markets weaken and consumers struggle to honor their obligations.[5]

Because of the MI industry's unique position we had good reason to be concerned with what was developing in the mortgage market even though these loans were generally done in a piggyback structure. Our fear – which proved to be valid – was that these practices would poison the well. As we noted in a September 23, 2005 letter to the bank regulators:

> Our concern is based in part on the fact that high-risk products can undermine reliance on proven forms of credit risk mitigation like private mortgage insurance (MI). But, far more disturbing to us is the fact that recent trends could lead to sudden increases in

[5] Letter dated December 3, 2002 from MICA to Hon. Susan Bies, Hon. James E. Gilleran, Hon. John D. Hawke, Jr., and the Hon. Donald E. Powell.

> foreclosures, accompanying sharp reductions in the value of residential mortgage collateral. This would, in effect, "pollute the residential mortgage well" – a well of profound importance to the depository institutions you regulate and to the mortgage insurance industry.[6]

Looking back it should not be a surprise that the MI industry was one of the first mortgage market participants to see the rapid deterioration in mortgage underwriting standards that was occurring and the dangers of piggyback mortgages. The MI industry by virtue of its private capital in the first loss position, its role as a reviewer of the underwriting of the loan, its counter-cyclical regulatory capital requirements and its long term view of housing market cycles had in the early 2000s and continues to have today a vested interest in a mortgage market that gives all parties incentives to put homeowners in mortgages that they can afford to pay over the long term. It is essential for the future health of the mortgage market that there remains private sector capital in this unique position.

It is important that mortgage insurers not be cut out of performing this vital function by not having loans they insure included in the QRM because no other entity is in the mortgage insurers' unique position. While under Dodd-Frank, FHA still will be able to insure low-down payment loans; FHA cannot perform the "canary in the coal mine" function because only government money is at risk, not private sector capital. In addition, FHA does not have the sophisticated analytical tools as do private mortgage insurers. Similarly, the bank regulators do not have the ability to move swiftly with market changes. They have the authority to promulgate regulations but this a cumbersome process. Note that the non-traditional mortgage guidance that was finalized in 2006 took four years to be completed with the regulators finally issuing a weak version of their initial proposal only after being called to account at a Senate Banking Committee hearing demanding action on the long-stalled standards. And, even when regulators began to act on the non-traditional mortgage guidance as the scope of the crisis became apparent, the only tool the agencies had at hand was a "guidance," not binding rules. As a result, many institutions disregarded regulatory injunctions to change mortgage lending practices despite the growing mortgage crisis.

**Conclusion**

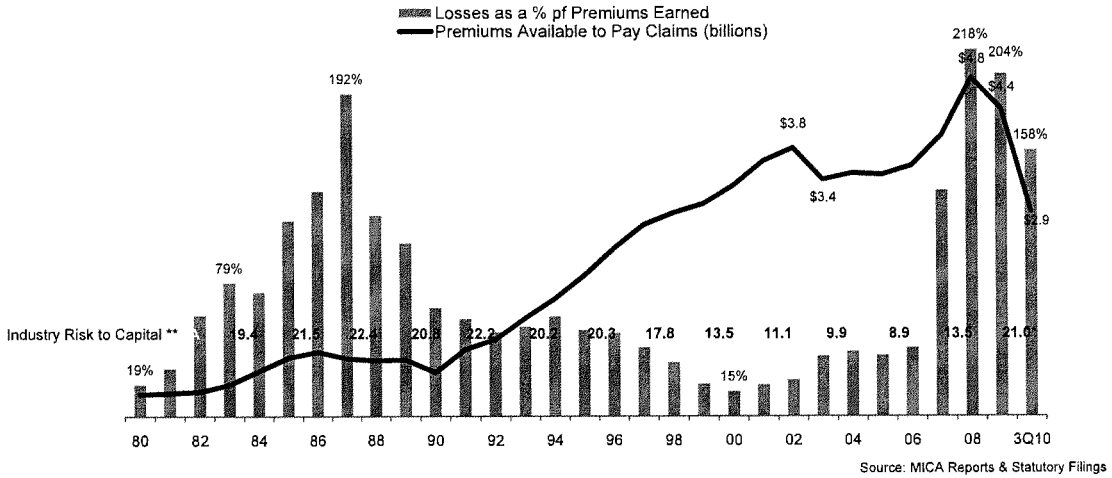
In summary, it is essential that privately insured loans be put on an equal footing with FHA-insured loans in the final version of the QRM. The private mortgage insurance model has withstood the test of time. We have helped house America for more than 50 years. We have been there through the tough times of the regional recessions of the 1980's and 1990's and of course through this recent national housing crisis. We will continue to work closely with borrowers, servicers and others to help people stay in their homes. Finally, we stand ready to play a critical role in the future of housing finance by safely and soundly enabling first-time and lower income families purchase homes.

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[6] Letter dated September 23, 2005 from MICA to Hon. Susan Bies, Hon. John Dugan, Hon. Donald Powell and the Hon. John M. Reich.

# Chart 1

## MIs Build Capital in Good Times to Pay Claims in Bad Times




Source: MICA Reports & Statutory Filings

- **Mortgage insurance is priced for long-term cycles.**
- **New business in recovery phase rebuilds capital base and replenishes contingency reserves.**

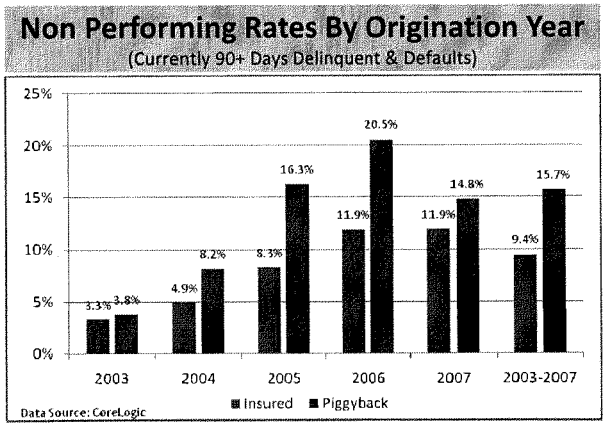
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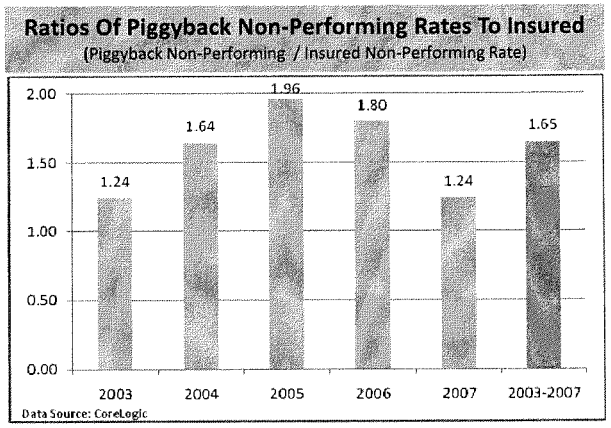
*2009 and 2010 Includes new entrant capital (Essent Guarantee)

**Dollar Amount of Industry Net Risk on Insured Mortgages Divided By Industry Regulatory Capital

# Chart 2
## Piggybacks Versus Insured Loans

- **Performance of Insured loans with combined loan to value ratios above 80% (High CLTV) Compared to High CLTV Piggyback loans (uninsured 1st liens with simultaneous 2nd liens)**
  - **CoreLogic Servicing Database**
  - **Origination years 2004 – 2007**
  - **Total # Loans = 4.9 million (1.1mm Piggyback; 3.8mm Insured)**
  - **Performance data for each normalized to the FICO & LTV distribution of the total population**
  - **Compared Percentage of Non-Performing Piggyback loans to Non-Performing Insured Loans by Origination Year, FICO group, CLTV and Geography**




**End Result ... Insured Low Downpayment Loans Have Lower Risk of Default than Comparable Piggyback Loans**




Good afternoon Chairman Garrett, Ranking Member Waters and members of the subcommittee. My name is Bram Smith and I am the Executive Director of the Loan Syndications and Trading Association, or LSTA. The LSTA has more than 300 member firms which consist of all types of participants in the syndicated commercial loan market, including large and regional U.S. banks, foreign banks, insurance companies, fund managers and other institutional lenders. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices in respect thereof, balancing the interests of all market participants.

Our testimony today will focus on one aspect of commercial loan financing – collateralized loan obligations, or CLOs. The LSTA appreciates the opportunity to appear here today to offer our views on how the recently proposed risk retention rules under the Dodd-Frank Act would impact the CLO market. Unfortunately, attempting to apply the risk retention rules to CLOs is like trying to fit a square peg into a round hole. **They simply don't fit**. The proposal, as currently drafted, would have a profoundly negative impact on CLOs – indeed, it could basically end CLO formation entirely. Since CLOs are a major lender to U.S. companies, this action could significantly reduce lending to American corporations and impact their ability to expand and create jobs. To be clear, the LSTA does not exclusively represent CLOs, though they number among our members. Rather, we are concerned about the impact that indiscriminate risk retention rules will have on lending itself.

In this testimony, I will discuss:

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- The importance of CLOs to U.S. corporate borrowers
- Why CLOs are different from "originate-to-distribute" asset backed securities ("ABS")
- Why the risk retention requirements recommended by the joint proposed rulemaking do not work for CLOs
- Why the approach taken in the joint proposed rulemaking is inconsistent with some of the mandates of the Dodd-Frank Act[1]
- Ways in which the joint proposed rulemaking does not follow the recommendations of the Federal Reserve's Risk Retention Study[2]
- Some alternative approaches to align interests in the CLO market – and keep this important source of corporate financing alive

**The Importance of CLOs to U.S. Corporate Borrowers**

The U.S. commercial loan market is critical to the success of American businesses. According to the Shared National Credit Review[3], which is run by the Federal Reserve, the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC"), in 2010 there were $1.2 trillion of funded syndicated commercial loans to U.S. companies. Lenders other than banks, such as insurance companies, finance companies, mutual funds and CLOs, provided more than $500 billion of these syndicated commercial and

[1] The "Dodd-Frank Wall Street Reform and Consumer Protection Act," Pub.L. No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act").
[2] Report to the Congress on Risk Retention, The Board of Governors of the Federal Reserve (Oct. 19, 2010), available at http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf ("Risk Retention Study").
[3] Credit Quality of the Shared National Credit Portfolio Improved in 2010, Shared National Credit Review (Sept. 28, 2010), available at http://www.federalreserve.gov/newsevents/press/bcreg/20100928a.htm.

industrial loans. CLOs, alone, provided $250 billion. Thus, CLOs provide more than 20% of the funded syndicated commercial and industrial loans to U.S. companies. The terms of the joint proposed rulemaking are unworkable for CLOs, and CLO formation will be dramatically reduced if the proposed risk retention requirements are not adapted to this asset class. If the proposed rules are not adjusted, this source of liquidity will dry up for U.S. companies. This is particularly unfortunate because, first, CLOs are not the "originate-to-distribute" ABS that the Dodd-Frank Act attempted to remedy and, second, CLOs performed well in the Global Financial Crisis.

**CLOs Are Not "Originate-to-Distribute" ABS**

FDIC Chairperson Sheila Bair noted that "[f]undamentally this rule is about reforming the 'originate-to-distribute' model for securitization and realigning the interests in structured finance."[4] **However, CLOs are not "originate-to-distribute" securitizations.** CLOs are not a way for banks to remove assets from their balance sheet. Instead, CLOs are a way for SEC registered investment advisors – like Eaton Vance or Invesco – to create an investment pool of syndicated loans. These independent third party asset managers, which have a fiduciary responsibility to their investors, seek out and purchase pieces of individual loans they believe are good investments – just like they would for a mutual fund. In addition, CLOs invest in a discrete number – roughly 150-250 – of individual corporate loans rather than the thousands held by a typical originate-to-distribute ABS. These commercial syndicated loans are subject to a robust

[4] Press Release, FDIC, Chairman Bair's Statement on Credit Risk Retention Notice of Proposed Rulemaking (Mar. 29, 2011), available at http://www.fdic.gov/news/news/press/2011/statement03292011.html.

credit approval process prior to origination. A potential borrower will usually engage a lead lender to arrange a syndicated loan for the borrower. The initial loan commitment is subject to a number of significant conditions precedent and each of the lenders will perform financial due diligence on the borrower. The final loan documentation is typically drafted by the lead lender's counsel, with input from the syndicate lenders. In addition, these loans are individually analyzed by the CLO manager and are very transparent, both for the manager and for investors. These loans are reported on in the press[5], they are priced daily by third party pricing services and more than $400 billion of these loans trade every year. Investors receive a monthly trustee report, which describes the performance of the CLO, highlights whether the CLO is passing all the tests found in its indenture, and details each loan asset. The manager actively buys and sells these loans when he believes there is an opportunity to avert losses on or improve the performance of the portfolio. Moreover, the manager *is hired and can be fired* by the CLO investors. **Crucially, the manager is only paid if the CLO performs**. As noted in the Federal Reserve's Risk Retention Study, the manager is not paid upfront, but is rather paid through a three-tier fee structure during the life of the CLO: A small amount of the fee (usually 10-20 basis points (bps)[6]) is paid prior to the note holders receiving their interest. This fee allows the manager to cover various costs such as rent and utilities. The bulk of the "running" fee (usually 30-40 bps) is paid only after the interest is paid on all of the CLO notes. Thus, if the CLO is not performing well and interest is not being paid on the notes, the CLO manager will not receive the bulk of his fees. Finally, the majority of CLOs also have an "incentive fee", which is paid toward the end of the life of the CLO.[7] This fee is paid only if all the CLO notes have received all their interest payments *and* the CLO equity has achieved a certain pre-negotiated rate of return. Thus, the vast

[5] See Thomson Reuters LPC, S&P/LCD and Credit Investment News.
[6] A basis point is 1/100th of one percent.
[7] Risk Retention Study, p. 46-47.

majority of the CLO manager's remuneration is tied to the performance of the CLO. This compensation structure ensures that the CLO manager's interests are aligned with the investors throughout the life of the CLO.

It is also important to note that CLOs performed very well in the worst financial crisis since the Great Depression. There are more than 630 cash flow CLOs outstanding today, and there have only been two payment defaults[8], neither of which caused losses for investors holding notes rated A or better. And, while there were ratings downgrades, they were relatively modest. For instance, 85% of the CLO notes originally rated Aaa by Moody's were still rated Aa or better following the downgrade sweep. Notably, a significant number of the downgrades were due to the rating agencies changing their criteria, making them considerably more stringent, rather than to a change in the quality of the CLOs. Moreover, recognizing that CLOs performed well, the rating agencies have been upgrading CLO notes since early 2010. There have been more than 430 CLO notes upgraded in the last three months alone. (See the appendix attached hereto for an example of the structure of a CLO.)

**The Joint Proposed Rulemaking Will Not Work for CLOs**

We appreciate the work the Agencies have done to prepare the proposed rules contained in the Notice of Proposed Rulemaking[9] ("Proposed Rules"). These Proposed Rules will cover many different "originate-to-distribute" products, whose outstandings total more than $10 trillion. With

[8] Moody's Investors Service.
[9] Notice of Proposed Rulemaking on Credit Risk Retention, the Agencies (Mar. 28, 2011), available at http://www.fdic.gov/news/board/29Marchno2.pdf.

such an overwhelming task, it is surely not surprising that the Agencies were not able to create a nuanced and workable regime for a $250 billion asset class – albeit one that is very important to U.S. companies. Indeed, CLOs appear not to have been given direct consideration in the Proposed Rulemaking. (The 376-page NPR's sole mention of CLOs outside of a volume table was footnote 42 designating the CLO manager as the "sponsor" even though the manager does not fit the literal definition of "securitizer" or "originator" as the Dodd-Frank Act envisioned for "originate-to-distribute" ABS.) Because CLOs are not "originate-to-distribute" ABS, the Proposed Rules' architecture simply does not work for them.

The Proposed Rules recommend five forms of retention:

- a "vertical slice" option, wherein the securitizer retains at least 5% of each liability tranche;
- a "horizontal residual interest" option, wherein the securitizer retains a first-loss position in an amount equal to at least 5% of the par value of all the ABS notes;
- a cash reserve fund option, wherein the securitizer establishes and funds an account in an amount equal to at least 5 percent of the par value of all ABS notes. The account will absorb losses in the same manner as a horizontal first-loss interest;
- an "L-Shaped" option, which consists of risk retention in both a vertical slice and a horizontal residual interest; and
- a representative sample option, which requires the securitizer to retain a randomly-selected pool of assets that are materially similar to the assets collateralizing the ABS issuance, measured as 5.264 percent of the unpaid principal balance of the securitized assets.

None of these options work for CLOs. Through a series of surveys that culminated last November, the LSTA polled asset managers that, collectively, manage $100 billion in CLOs. According to our survey, just 13% of respondents have the capacity and the structure that might allow them to retain a vertical slice option. (However, several respondents that said that they could theoretically hold a vertical strip added that they might not be able to justify deploying scarce capital to do so.) The vertical slice is thus either not allowed or is uneconomic for CLOs. For similar reasons, the L-shaped option is also unfeasible. Likewise, while a representative sample option might theoretically be feasible, the Proposed Rules require the sample to be drawn from a pool of at least 1,000 separate assets. As most CLOs manage only 100-200 assets, they simply do not have 1,000 separate assets to draw from. This is another clear example of how, despite the Agencies' efforts, the Proposed Rules were written without fully considering products like CLOs.

In the LSTA's survey, the only option that CLO managers said was even marginally feasible was the horizontal first loss strip – but only if it was of a reasonable size. Unfortunately, the Agencies have substantially over-estimated the necessary size of the horizontal first loss strip, focusing on the par value of the ABS rather than on the credit risk of the assets, as required by the Dodd-Frank Act. As discussed more fully below, because the horizontal first-loss position imposes a 5% retention of the entire value of the ABS, it incorrectly assumes that the credit risk of every ABS is 100% (i.e., that the entire portfolio will default and suffer a 100% loss given default). As we explain below, the horizontal first-loss position as currently proposed would impose on the CLO manager a retention requirement far in excess of the 5% of the *credit risk* of the ABS contemplated by the Dodd-Frank Act. Thus, a first loss position of an amount equal to at least

5% of the par value of all the ABS notes *is a far larger risk position than all the other retention options.* Moreover, it is not consistent with the explicit language of Section 941(b) of the Dodd-Frank Act, which requires retention of a portion of the "credit risk" and not of the par value of the assets.

We appreciate the fact that the Agencies structured a number of retention options that fit many asset classes, and encourage them to continue to offer all the proposed options. However, we would like to use a numerical example to illustrate how, while the vertical pro rata strip option captures 5% of the credit risk of the portfolio, a first loss position of 5% of the par value of the ABS notes is far in excess of 5% of the credit risk of the assets. Suppose there is a hypothetical $400 million CLO with five note tranches rated from AAA (senior-most and least likely to suffer losses if there are losses in the portfolio of assets) to unrated equity (junior-most and most likely to suffer losses if there are losses in the portfolio of assets). The first four note tranches are each $95 million, and there is a $20 million equity/first loss tranche at the bottom of the CLO's capital structure. The Proposed Rules say that a sponsor can retain risk either in a vertical slice ($4.75 million of each of the first four notes and $1 million of the equity note) or in a horizontal slice ($20 million in the first loss, equity slice). If the portfolio suffers losses, the losses will accrue from the bottom (the equity) up. For instance, suppose the portfolio of loans suffers $20 million of losses. In this case, the equity note will absorb all the losses and will be completely wiped out. If the sponsor held a 5% vertical slice of each note tranche, he would lose $1 million (or, 5% of the credit losses – just as the Dodd-Frank Act intended). If the sponsor held his risk retention in a horizontal first loss position (the equity tranche), he would lose $20 million (or 100% of the

credit losses – far more than the Dodd-Frank Act intended)[10]. These are not the same outcomes, yet the Proposed Rules treat them as though they are. Consequently, we request that the final rules reflect a consistent approach to risk retention, i.e., first loss retention equal to 5% of the credit risk.

**5% "First Loss" Retention is Far More Than 5% of Credit Risk**

The reason these two are not the same is because the Proposed Rules assume that 5% of the par value of the ABS (in any form) and 5% of the credit risk are the same thing. As the above example illustrates, they are not the same because the credit losses are concentrated in the first loss position. Importantly, the Dodd-Frank Act requires the securitizer to retain "an economic interest in a portion of the ***credit risk*** for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells or conveys to a third party," [11] and the Agencies have generally determined that 5% is the appropriate "economic interest". However, a first loss position of at least 5% of the par value of the ABS is far more than 5% of the credit risk of the assets.

The annual mean expectation of credit risk is "expected loss". Expected loss is simply the amount of money a lender can expect to lose due to defaults in a portfolio of loans. Expected loss for a funded loan can be calculated as 1) probability a company will default multiplied by 2) how much of the loan value the lender will lose if the company defaults.

[10] The Risk Retention Study provides an example of how the losses "flow up" on a tranched securitization. See Risk Retention Study, p. 12-14.
[11] Section 941(b) of the Dodd Frank Act (codified at 15 U.S.C. §78o-11(b)(1)).

A real world example may be useful. On average, approximately 3.15% of B1 rated commercial syndicated loans default every year[12]. Because commercial loans that are held in CLOs are the most senior debt in the borrower's capital structure and because they are typically secured by the majority of the borrower's assets, even when these loans default, the lender still recovers a substantial amount of its loan. In other words, the loan will have a high "recovery given default". Based on 1,800 observations since 1988, the average "recovery given default" of senior, secured commercial loans is 80 cents on the dollar[13] of the defaulted loan. Conversely, "loss given default" – the amount that is not recovered – is only 20 cents on the dollar of the defaulted loan.[14]

All told, the expected loss on a portfolio of single-B rated commercial loans that is held for 10 years is 5.4 cents on the dollar. For a $400 million CLO, this means the CLO's expected loss is $21.6 million after 10 years. *The entire expected loss is $21.6 million.* The Dodd-Frank Act generally requires the securitizer to hold 5% of the credit risk. In this case, 5% of the credit risk (defined as expected loss) would be $1.08 million. However the Proposed Rule would require the sponsor that is retaining through the horizontal slice to hold $20 million of a first loss piece – *more than 18 times what the Dodd-Frank Act mandates.*

**The Commercial Loan Exemption is Unworkable**

[12] Moody's Investors Service.
[13] Moody's Investors Service Report: Hard Data for Hard Times II: The Crisis That Wasn't, Moody's Global Credit Research (Feb. 23, 2011).
[14] Notably, this recovery rate was consistent even through the Global Financial Crisis.

The Proposed Rules theoretically offer a means by which loans with sufficient underwriting standards can be exempted from retention requirements. Unfortunately, the criteria are drawn so narrowly that virtually no commercial loan qualifies. For two years before and after the closing of the loan, the borrower must have i) a total liabilities ratio of 50% or less, ii) a leverage ratio of three or less, and iii) a debt service coverage ratio of 1.5 or greater. [15] In addition, the term must be five years or less, and repayment must come solely from business revenues (and not asset sales or refinancings) and be based on straight-line amortization.[16]

Here are some examples of companies whose commercial loans would not qualify for the exemption: General Electric Capital Corp., AT&T, Wal-Mart, Johnson & Johnson, Verizon Communications, Chevron Corp., Pfizer Inc., Time Warner Inc, Hewlett-Packard, Kraft Foods, PepsiCo, UPS and Deere & Co.

If these companies, which are some of the strongest in America, do not meet these narrow criteria, then it is clear that this exemption for underwriting standards is all but unworkable.

Moreover, even if more than a handful of loans qualified for the exemption, the Proposed Rules also introduce requirements that do not reflect CLO market practices. For instance, the Exemption under the Proposed Rules prohibits CLOs from reinvesting in new loans and does not

[15] Total liabilities ratio "equals the borrower's total liabilities, determined in accordance with GAAP divided by the sum of the borrower's total liabilities and equity, less the borrower's intangible assets, with each component determined in accordance with GAAP." NPR, n. 168.
Leverage ratio "equals the borrower's total debt divided by the borrower's annual income before expenses for interest, tax, depreciation, and amortization (EBITDA), as determined in accordance with GAAP." NPR, n. 169.
Debt service coverage ratio "equals the borrower's EBITDA, as of the most recently completed fiscal year divided by the sum of the borrower's annual payments for principal and interest on any debt obligation." NPR, n. 170.
[16] "Under the proposed rules, the loan payments under the commercial loan must be determined based on straight-line amortization of principal and interest that fully amortize the debt over a term that does not exceed five years from the closing date for the loan." NPR, p. 151.

allow managers to purchase loans more than six months after their closing date. Both of these criteria are counter to the active management that investors seek from CLO managers.

**The Proposed Rulemaking Does Not Follow the Recommendations of the Risk Retention Study**

The Dodd-Frank Act required the Federal Reserve to conduct a study ("Risk Retention Study") "of the combined impact on each individual class of asset backed security of the new credit risk retention requirements and make recommendations for eliminating any negative impacts on the continued viability of the asset backed securitization markets and on the availability of credit for new lending."[17]

In its Risk Retention Study, the Federal Reserve recommended that in writing rules, the Agencies should:

- Consider the specific incentive alignment problems to be addressed by each credit risk retention requirement established under the jointly prescribed rules.
- Consider the economics of asset classes and securitization structure in designing credit risk retention requirements.
- Consider the potential effect of credit risk retention requirements on the capacity of smaller market participants to comply and remain active in the securitization market.

[17] Section 941(c) of the Dodd-Frank Act.

- Consider the potential for other incentive alignment mechanisms to function as either an alternative or a complement to mandated credit risk retention.
- Consider the interaction of credit risk retention with both accounting treatment and regulatory capital requirements.
- Consider credit risk retention requirements in the context of all the rulemakings required under the Dodd–Frank Act, some of which might magnify the effect of, or influence, the optimal form of credit risk retention requirements.
- Consider that investors may appropriately demand that originators and securitizers hold alternate forms of risk retention beyond that required by the credit risk retention regulations.
- Consider that capital markets are, and should remain, dynamic, and thus periodic adjustments to any credit risk retention requirement may be necessary to ensure that the requirements remain effective over the longer term, and do not provide undue incentives to move intermediation into other venues where such requirements are less stringent or may not apply.[18]

In particular, the Risk Retention Study recommended that the Agencies consider "the economics of asset classes and securitization structure in designing risk retention requirements."[19] As none of the Proposed Rules' retention requirements could be utilized for most CLOs, it clearly does not address CLOs as a unique asset class.

The Risk Retention Study also recommended that the Agencies "consider potential effect of credit risk retention requirements on the capacity of smaller market participants to comply and

[18] Risk Retention Study, p. 3-4.
[19] Risk Retention Study, p. 83.

remain active in the securitization market."[20] Just 13% of the respondents to the LSTA's CLO manager survey could retain risk in a vertical slice; no smaller managers were able to hold retention in this fashion. Clearly this is counter to the Federal Reserve's recommendation.

The Risk Retention Study also explicitly recommended that the Agencies "consider the potential for other incentive alignment mechanisms to function as either an alternative or a complement to mandated credit risk retention."[21] In fact, in its Risk Retention Study, the Federal Reserve specifically noted that for CLOs "alignment is typically accomplished by compensating the CLO managers using a performance-based fee structure."[22] However, these potential alternative forms of alignment are absent from the Joint Proposed Rulemaking.

**Recommendations**

We appreciate the vast amount of work the Agencies have done in a remarkably short period of time, and we likewise appreciate the opportunity to provide input on how the Proposed Rules could be fine-tuned so as to be appropriate for CLOs.

As explained above, CLOs are not "originate to distribute" ABS. The CLO manager is an independent third party, with fiduciary responsibility to his investors, who actively seeks out and manages loan assets via a CLO. Therefore, CLOs do not fit within the spirit of the risk retention provisions of the Dodd-Frank Act. **And so, we believe it is appropriate and prudent to expressly exclude them.**

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[20] Risk Retention Study, p. 83.
[21] Id.
[22] Risk Retention Study, p. 46.

However, if the Agencies see fit to include CLOs, we believe it is important to consider ways to optimize the alignment of interests without shuttering this important source of financing to U.S. companies, which are the engine of job growth. We have three specific recommendations.

First, as discussed in the Federal Reserve's Risk Retention Study, we believe the Agencies should further investigate and consider the three-tier fee structure in CLOs that already exists. Because CLO managers do not receive the vast majority of their remuneration unless i) all note tranches are receiving all their contractual payments and ii) the equity tranche has earned a pre-negotiated rate of return, we believe the fee structure would continue to work exceptionally well as a means to align incentives.

Second, if – counter to the Federal Reserve's recommendations – the Agencies determine that risk retention is the only acceptable form of alignment, we would ask that they consider several additional alternatives. First, we recommend that the Agencies consider a retention option that is similar to that offered to commercial mortgage backed securitizations ("CMBS"), i.e., risk "retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such first loss position."[23] We think this approach is worth pursuing for CLOs recognizing that, first, the Proposed Rules, as written, have considerable challenges that must be resolved before they can be effective for CMBS and, second, the Proposed Rules would need to reflect the differences between CMBS and CLOs.

[23] Section 941(b) of the Dodd-Frank Act (codified at 15 U.S.C. §78o-11(c)(1)(E)).

This approach is also consistent with that of the Committee of European Bank Supervisors ("CEBS") which explicitly accepted the retention of the first-loss position by a third party investor for risk alignment in CLOs.[24] Although Europe's Risk Retention legislation also has significant drawbacks with respect to CLOs, in part because the European Regulators had no ability to apply nuanced rulemaking, we believe the fact that CEBS recognized that CLOs were not originate-to-distribute ABS and attempted to provide alternatives demonstrates that regulatory alternatives are necessary.

Finally, we ask that the Agencies, when finalizing the rules for a "horizontal residual interest" option, ensure that the option captures 5% of the *credit risk* of the portfolio, rather than being equivalent to 5% of the face value of the ABS notes. As we demonstrated above, a first loss position of 5% of the face value of the ABS notes is many multiples of 5% of the credit risk of the pool of assets.

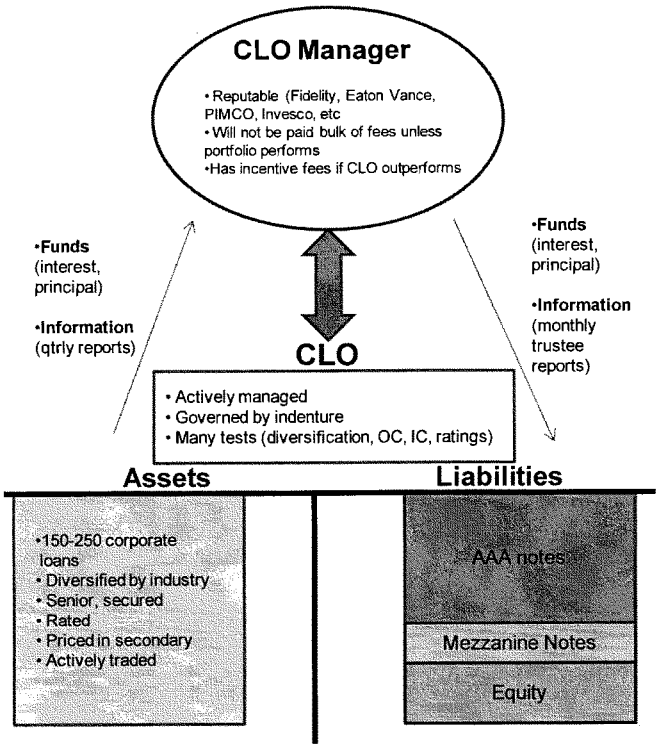
We again appreciate the opportunity to testify before this august committee and we look forward to working constructively with the Agencies to help produce rules that both align the interests of securitizers and investors *and* ensure that this important source of financing to Corporate America is not shut off.

Thank you.

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[24]Committee of European Banking Advisors, Feedback to the public consultation on Guidelines to Article 122a of the Capital Requirements Directive (Dec. 31, 2011), available at http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Feedback-document.pdf.

**APPENDIX: Example of a CLO structure**



For Release Upon Delivery
2:00 p.m., April 14, 2011

**TESTIMONY OF**

**JULIE WILLIAMS**
**FIRST SENIOR DEPUTY COMPTROLLER AND CHIEF COUNSEL**
**OFFICE OF THE COMPTROLLER OF THE CURRENCY**

**Before the**

**SUBCOMMITTEE ON CAPITAL MARKETS AND**
**GOVERNMENT SPONSORED ENTITIES**
**FINANCIAL SERVICES COMMITTEE**
**UNITES STATES HOUSE OF REPRESENTATIVES**

**April 14, 2011**

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Chairman Garrett, Ranking Member Waters, and members of the Subcommittee, I appreciate the opportunity to describe the interagency rule proposal on risk retention in asset-backed securitization, required by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). My testimony describes the proposed rule and discusses key issues on which the agencies are requesting comment.

During the financial crisis, certain factors at work in the securitization markets distorted incentives for market participants in ways that led to broad problems for consumers and the financial markets. Loan originators were able to underwrite low quality or even fraudulent loans for sale through securitization, without any exposure of the originator or securitizer to the future credit risk of the loans. Section 941 of the Dodd-Frank Act[1] was designed to address this aspect of the problem by requiring the securitizer to retain a portion of the credit risk on assets it securitizes, with exceptions from this risk retention requirement available only for loans in asset classes designated by regulators that satisfied underwriting standards that resulted in low credit risk. The goal was to give securitizers direct financial disincentives against packaging loans that are underwritten poorly.[2]

The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission (SEC) are required by section 941 to issue joint

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[1] 12 USC 78o-11 (2010).

[2] Section 941 is but one element of the Dodd-Frank Act's provisions addressing failures in the securitization markets exposed by the financial crisis. Among other things, the Dodd-Frank Act also improves the transparency of credit ratings and strengthens oversight of the ratings agencies, provides registered ABS investors detailed information about the assets underlying the ABS, and provides ABS investors with information about the securitizer's history with regard to asset repurchase activity. See sections 932, 935, 936, 938, 942, and 943.

regulations requiring securitizers of asset-backed securities (ABS) to retain an economic interest in a portion of the credit risk for assets that the securitizer packages into the securitization for sale to others. Where the regulations address the securitization of residential mortgage assets, the Department of Housing and Urban Development (HUD) and the Federal Housing Finance Agency (FHFA) are also part of the joint rulemaking group. The Treasury Secretary, as Chairperson of the Financial Stability Oversight Council, is directed to coordinate the joint rulemaking.[3]

The agencies are required to define the appropriate form and amount of risk retention interests to be held by securitizers, and to consider circumstances in which it might be appropriate to shift the retention obligation to the originator of the securitized assets. The statute also requires the agencies to formulate a number of exemptions from the risk retention requirements. One such exemption is the criteria for loans meeting an exemption for "qualified residential mortgages" (QRMs) with underwriting and product features that historical loan performance data indicate result in a lower risk of default. The statute also requires the agencies to establish underwriting standards indicative of low credit risk for certain other classes of assets used in securitizations -- commercial mortgages, commercial loans, and auto loans -- and to determine how much the risk retention threshold for securitizations of assets meeting those underwriting criteria should be reduced below the five percent minimum generally prescribed by the statute.

[3] For simplicity's sake, this statement refers to the joint rulemaking group as "the Agencies," without distinguishing which members of the group are assigned responsibility for making the various determinations required under section 941.

## I. Proposed Forms of Risk Retention Include Numerous Options Designed to Reflect the Diversity of the Securitization Markets

As the FRB has noted in its recent study of the securitization markets (also required by section 941 of the Dodd-Frank Act), the securitization markets provide an important mechanism for making credit available for businesses, households, and governments.[4] This liquidity function manifests itself as a remarkably diverse set of securitization channels spanning across at least ten major asset classes, encompassing not only the familiar consumer classes, such as residential mortgage backed securities and credit card and auto securitizations, but also assets such as commercial loans, commercial mortgages, and equipment loans and leases. The securitization markets also rely on different structures, ranging from simple "pass through" securities that ratably distribute principal and interest payments on a pool of underlying mortgages, to tranched securitizations with internal credit enhancements, multi-seller asset-backed commercial paper conduits (ABCPs), revolving asset master trusts, and other specialized structures. In developing the risk retention rules, the Agencies sought to take this diversity into account, based on our concern that a "one size fits all" approach to risk retention would not be workable across the market, and would stifle the re-emergence of sound securitization activity.

As described in Section II of this statement, the proposed rule prescribes underwriting criteria for QRMs and certain other asset classes, and provides that sponsors of securitizations exclusively comprised of these "qualified assets" are not required to retain risk under section 941. However, as is appropriate for an exemption from the risk

[4] Report to Congress on Risk Retention, Board of Governors of the Federal Reserve System (October 2010).

retention requirement, these underwriting standards are conservative. For other types of loans that do not qualify for exemption from the risk retention requirements, the Agencies have sought to structure the proposed risk retention requirements in a flexible manner that will allow the securitization markets for non-qualified assets to function in a manner that both facilitates the flow of credit to consumers and businesses on economically viable terms and is consistent with the protection of investors.

*A. The "Sponsor" Retains the Risk*

Section 941 creates a new section 15G of the Securities Exchange Act of 1934,[5] requiring the Agencies to issue rules requiring securitizers – the firms that organize and initiate securitization transactions – to retain at least five percent of the credit risk of the securitized assets. The nomenclature of the proposed rule refers to the securitizer as the "sponsor" of the securitization transaction, consistent with the SEC's disclosure regulation for registered asset-backed securitizations, Regulation AB. Practically speaking, the sponsor is the true decision-maker behind the securitization transaction and determines what assets will be securitized. In light of this, the proposed rule generally requires the sponsor to be the party that retains the five-percent risk interest under section 15G.

*B. Different Ways to Satisfy the Risk Retention Obligation*

Section 15G charges the Agencies with determining the form of the retention interest to be held by the sponsor, and the duration that interest must be held. Consistent with the statute, the proposed rule generally would require a sponsor to retain an

[5] 15 U.S.C. 780-11.

economic interest equal to at least five percent of the aggregate credit risk of the assets collateralizing an issuance of ABS (the "base" risk retention requirement), for the duration of the securitization.

In designing options for risk retention under rule, the Agencies took into account not only the flexibility that we believe will be necessary to allow sponsors to structure retention interests that will meet investors' concerns with respect to the alignment of interests between sponsors and investors, but also the structures used by sponsors to satisfy investor demands for risk retention in past and recent markets.

The proposed rule provides several options for the form in which a securitization sponsor may retain risk. These include:

- A five percent "vertical" slice of the ABS interests, whereby the sponsor retains a specified *pro rata* piece of every class of interests issued in the transaction;
- A five percent "horizontal" first-loss position, whereby the sponsor retains a subordinate interest in the issuing entity that bears losses on the assets before any other classes of interests;
- An "L-shaped interest" interest whereby the sponsor holds at least half of the five percent retained interest in the form of a vertical slice and half in the form of a horizontal first-loss position;
- A "seller's interest" in securitizations structured using a master trust collateralized by revolving assets whereby the sponsor holds a five percent separate interest that is *pari passu* with the investors' interest in the pool of receivables (unless and until the occurrence of an early amortization event);

- A representative sample, whereby the sponsor retains a five percent representative sample of the assets to be securitized, thereby exposing the sponsor to credit risk that is equivalent to that of the securitized assets; or
- For certain "eligible" single-seller or multi-seller asset-backed commercial paper conduits collateralized by loans and receivables and covered by a 100 percent liquidity guarantee from a regulated bank or holding company, a five percent residual interest is retained by the receivables' originator-seller.[6]

The proposed rule also provides that Fannie Mae and Freddie Mac (the Enterprises) are deemed to satisfy the five percent risk retention requirement through their guarantees, under which they retain 100 percent of the credit risk of the mortgages backing their securities, as long as the Enterprises continue to operate under the conservatorship or receivership of the FHFA and with direct government support through the Treasury Department's Senior Preferred Stock Purchase Agreement. The Agencies recognize the importance of reform of the Enterprises, and expect to revisit and appropriately modify this aspect of the rules after the future of the Enterprises becomes clearer. The issues raised by the treatment of the Enterprises in the proposed rule are further discussed in Section II of this statement.

*C. Prohibitions on Transfer of Risk Retention Interests*

To increase the sponsor's incentive to monitor the underwriting quality of assets the sponsor selects to back an ABS deal, the proposed rule requires the sponsor to hold the required retention interest for the full life of the securitization transaction. Consistent

[6] This option would not be available to ABCP programs that operate as SIVs or securities arbitrage programs.

with section 15G, the proposed rule also provides that sponsors cannot sell or transfer the interests they are required to retain under the rule, and cannot hedge the credit risk away. However, to allow sponsors to continue managing the overall credit risk of their operations, portfolio hedging is not prohibited.

The proposed rule would also permit transfer of risk retention in two specific circumstances as contemplated by section 15G:

- The Agencies propose to exempt from the transfer prohibition certain securitizations of commercial mortgage-backed securities (CMBS) for which a form of horizontal risk retention often has been employed, with the horizontal first-loss position initially being held by a third-party purchaser (known in the securitization markets as a "B-piece buyer") that specifically negotiates for the purchase of the first-loss position and conducts its own credit analysis of each commercial loan backing the CMBS.[7]
- The Agencies also propose to permit a sponsor to allocate a proportional share of the risk retention obligation (through a voluntary contractual agreement) to the originator(s) of the securitized assets, subject to certain conditions, if the originator in question originated at least 20 percent of the assets in the securitization pool. To ensure the originator has "skin in the game," the proposal requires the originator to pay up front for its share of retention, either in cash or a discount on the price of the loans the originator sells to the pool. The originator must also agree to hold the retention interest subject to the same prohibition against the hedging or transferring of the credit risk that would apply to sponsor.

[7] If the third-party purchaser also serves as the special servicer of troubled assets in the pool, the proposal also requires appointment of an independent Operating Advisor to oversee servicing.

*D. Premium Capture Cash Reserve Account*

In many securitization transactions prior to the financial crisis, the transactions were structured to include a risk retention piece. However, the sponsors were able to sell premium or interest-only tranches to investors for prices that more than offset the sponsors' costs for the amount of the risk retention. These tranches were funded by "excess spread" interest income expected to be generated by securitized assets over time, which reflected the higher credit risk of, and likely losses on, those securitized assets (such as subprime mortgages). This enabled sponsors to obtain up-front payment for that excess spread at the inception of the transaction, before the losses on the securitized assets appeared – which more than compensated for the sponsor's exposure through risk retention. This created incentives for securitizers to issue many complex securitization transactions of high credit-risk, high-yield assets. It also made the risk retention illusory from an incentive standpoint, because the sponsor was paid more for the excess spread than the sponsor's overall cost for the retention interests.

The Agencies propose to address this problem thorough the proposed rule. If a sponsor structures a securitization to monetize excess spread on the underlying assets – by selling a tranche of the transaction that would be funded by excess spread income – without making an offsetting increase in the risk retention piece, the proposed rule would capture the premium or purchase price received on the sale of the tranches that monetize the excess spread and require that the sponsor place such amounts into a separate "premium capture cash reserve account" in the securitization. The amount placed into the premium capture cash reserve account would be separate from and in addition to the

sponsor's base risk retention requirement, and would be used to cover losses on the underlying assets before such losses were allocated to any other interest or account. The purpose of the account is to keep sponsors from taking an up-front profit on a securitization of high-yield assets that would effectively pay off the sponsor for the risk retention interest it is required to retain, and to keep that excess spread available to cover losses on the assets in the securitization.

*E. Exemptions for Low Risk Assets*

As discussed in Section II of this statement, Section 15G provides a complete exemption from the credit risk retention requirements for ABS collateralized solely by QRMs meeting terms and conditions defined by the Agencies in the implementing regulations. In addition, the proposed rule also would not require a securitizer to retain any portion of the credit risk associated with a securitization transaction if the ABS issued are exclusively collateralized by commercial loans, commercial mortgages, or automobile loans that meet underwriting standards included in the proposed rule. As in the case of QRMs, these underwriting standards are designed to be robust and ensure that the loans backing the ABS are of very low credit risk. These standards were developed by the federal banking agencies based upon their supervisory expertise.

However, these underwriting standards do not cover every class of assets that have historically been used to back securitization transactions. Because in some cases securitization transactions involve assets with significant diversity within the transaction, or in other cases assets that by their nature exhibit relatively high credit risk, the Agencies

concluded that it would be extremely difficult as a practical matter to establish workable underwriting standards for them by regulation.

*F. Disclosure Requirements*

The proposed rule also includes disclosure requirements specifically tailored to each of the permissible forms of risk retention. The disclosure requirements are designed to provide investors with material information concerning the securitizer's retained interests, such as the amount and form of the interest retained, and the assumptions used in determining the aggregate value of ABS to be issued (which generally affects the amount of risk required to be retained). Further, the disclosures are designed to provide investors and the Agencies with an efficient mechanism to monitor compliance.

## II. Particular Issues of Note

*A. Criteria for Qualified Residential Mortgages*

Section 15G provides a complete exemption from the credit risk retention requirements for ABS collateralized solely by QRMs. The proposed rule establishes the terms and conditions under which a residential mortgage would qualify as a QRM.

Section 15G requires the Agencies to define QRM, "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default." A substantial body of evidence, including data analyzed by the Agencies during the rulemaking and academic literature, supports the view that the underwriting criteria in the proposed rule have low credit risk, even in severe economic conditions. The proposed QRM underwriting criteria are also consistent with the premise

that a complete exemption from risk retention should be supported by very high quality mortgage loans.

The proposed rule generally would prohibit QRMs from having product features that contributed significantly to the high levels of delinquencies and foreclosures since 2007—such as failure to document income, "teaser" rates, or terms permitting negative amortization or interest-only payments—and also would establish conservative underwriting standards designed to ensure that QRMs are of high credit quality. As required by the statute, these standards were developed through evaluation of historical loan performance data that are described in the preamble to the proposal. These underwriting standards include, among other things, maximum front-end and back-end debt-to-income ratios of 28 percent and 36 percent, respectively;[8] credit history restrictions, including no 60-day delinquencies within the previous 24 months; a maximum loan-to-value (LTV) ratio of 80 percent in the case of a purchase transaction (with a 75 percent combined LTV for refinance transactions, reduced to 70 percent for cash-out refis); and a 20 percent down payment requirement in the case of a purchase transaction. The Agencies propose to require the LTV to be calculated without taking any mortgage insurance into consideration.

The OCC is interested in the feedback we will receive on this aspect of the proposal. If the Agencies are persuaded that the QRM underwriting criteria are too restrictive on balance, the preamble discusses several possible alternatives. One would be to permit the use of private mortgage insurance obtained at origination of the mortgage for loans with LTVs higher than the 80 percent level specified in the proposed rule. The

[8] To reduce complexity of the rulemaking, the proposed rule incorporates existing FHA standards for determining and documenting DTI ratios.

guarantee provided by private mortgage insurance, if backed by sufficient capital, lowers the credit risk to investors by covering the unsecured losses attributable to the higher LTV ratio once the borrower defaults and the loan is liquidated. However, to include private mortgage insurance in the QRM criteria, Congress required the Agencies to determine that the presence of private mortgage insurance lowers the risk of default -- not that it reduces the ultimate amount of the loss. The OCC will be interested in the information provided by commenters on this topic, and any data they can provide.

Other alternatives discussed in the proposal are (i) imposing less stringent QRM underwriting criteria, but also imposing more stringent risk retention requirements on non-QRM loan ABS to incentivize origination of the QRM loans and reflect the relatively greater risk of the non-QRM loan market, and (ii) creating an additional residential mortgage loan asset class along side the QRM exemption – like the underwriting asset classes for commercial loans, commercial mortgages, and auto loans under the proposed rule – with less stringent underwriting standards or private mortgage insurance, subject to a risk retention requirement set somewhere between zero and five percent.

*B. Inclusion of Servicing Standards in the QRM Definition; National Mortgage Servicing Standards*

Another issue that has attracted attention in connection with the criteria for a QRM is whether mortgage servicing standards should be part of the QRM requirements. The proposed rule includes a limited set of such requirements that may lower the risk of default on residential mortgages. The requirements focus on establishing a process for

the creditor to take loss mitigation activities that lower the risk of default into account in servicing QRMs, but they do not dictate particular types of actions to be undertaken.

The proposed rule requires inclusion of terms in the mortgage transaction documents under which the creditor commits to have servicing policies and procedures to mitigate risk of default. The policies and procedures must address loss mitigation actions to be taken by the creditor, such as loan modifications or other loss mitigation alternatives, in the event the estimated resulting net present value of the loss mitigation action exceeds the estimated net present value of recovery through foreclosure, without regard to whether the particular loss mitigation action benefits the interests of a particular class of investors in a securitization. The creditor must also implement procedures for addressing any whole loan owned by the creditor (or any of its affiliates) and secured by a subordinate lien on the same property that secures the first mortgage loan if the borrower becomes more than 90 days past due on the first mortgage loan. These procedures could include steps ranging from enhanced loan loss reserves and loss recognition on the loan secured by the subordinate lien, to modification or restructuring of that loan. The procedures must be disclosed to the borrower, and if the creditor transfers servicing rights for the mortgage loan, the transfer agreement must require the transferee to abide by these commitments of the creditor, as if the transferee were the creditor under this section of the proposed rule.

The Agencies have included numerous requests for comment about the servicing standards in the proposed rule, including their feasibility, the authority under section 15G to pursue any servicing alternatives, and the important question whether comprehensive national mortgage servicing standards would be a more effective and transparent

approach. Recent experience and the major enforcement actions just announced by the federal banking agencies highlight the need for uniform standards for mortgage servicing that apply not just to delinquent loans, but to all facets of servicing the loan, from loan closing to payoff or foreclosure. To be meaningful and effective, the OCC believes that mortgage servicing standards should apply uniformly to *all* mortgage servicers and provide the same safeguards for consumers, *regardless* of whether a mortgage has been securitized. Furthermore, a key driver of servicing practices has been and continues to be secondary market requirements. We will not achieve improvements in mortgage servicing without corresponding changes in requirements imposed by the GSEs, and it is also vital that robust and consistent mortgage servicing standards are applicable to – and actually implemented by – nonbank firms engaged in mortgage servicing.

To further this effort and discussion, the OCC developed a framework for comprehensive mortgage servicing standards that we shared with other agencies, and we are now participating in an interagency effort[9] to develop a set of comprehensive, nationally applicable mortgage servicing standards, which take into account numerous servicing issues not addressed in the proposed rule. Our objective is to develop uniform standards that govern processes for:

- Handling borrower payments, including applying payments to principal and interest and taxes and insurance before they are applied to fees, and avoiding payment allocation processes designed primarily to increase fee income;

[9] Participating agencies in the effort include the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the Federal Housing Finance Agency, the Department of Housing and Urban Development (including the Government National Mortgage Association (Ginnie Mae)), the Consumer Financial Protection Bureau, and the Department of the Treasury.

- Providing adequate borrower notices about their accounts and payment records, including a schedule of fees, periodic and annual statements, and notices of payment history, payoff amount, late payment, delinquency, and loss mitigation;
- Responding promptly to borrower inquiries and complaints, and promptly resolving disputes;
- Providing an avenue for escalation and appeal of unresolved disputes;
- Effective incentives to work with troubled borrowers, including early outreach and counseling;
- Making good faith efforts to engage in loss mitigation and foreclosure prevention for delinquent loans, including modifying loans to provide affordable and sustainable payments for eligible troubled borrowers;
- Implementing procedures to ensure that documents provided by borrowers and third parties are maintained and tracked so that borrowers generally will not be required to resubmit the same documented information;
- Providing an easily accessible single point of contact for borrower inquiries about loss mitigation and loan modifications;
- Notifying borrowers of the reasons for denial of a loan modification, including information on the NPV calculation;
- Implementing strong foreclosure governance processes that ensure compliance with all applicable legal standards and documentation requirements, and oversight and audit of third party vendors;

- Not taking steps to foreclose on a property or conduct a foreclosure sale when the borrower is approved under a trial or permanent modification and is not in default on the modification agreement; and
- Ensuring appropriate levels of trained staff to meet current and projected workloads.

*C. Risk Retention for Fannie Mae and Freddie Mac*

As discussed in Section I of this statement, the proposal recognizes as a permissible form of risk retention the Enterprises' 100 percent guarantee of principal and interest payments on MBS sponsored by the Enterprises. Through this guarantee, the Enterprises retain 100 percent of the credit risk in the transaction.

Since release of the proposal, some have expressed concerns that this aspect of the proposed rule disadvantages private securitizers, which will incur the funding costs of holding a five percent interest in each ABS they sponsor relative to the Enterprises. The Agencies are very cognizant of the complex issues affecting the treatment of the Enterprises under the proposal and look forward to considering the comments we receive. The approach contained in the proposal reflects several factors: 1) the Enterprises already retain 100 percent of the credit risk in each ABS they sponsor as a result of their guarantees; 2) requiring the Enterprises to retain a five percent interest in each ABS they sponsor would significantly increase their holdings of mortgage-backed securities at a time when there is strong interest in reducing such holdings; 3) the proposed rule's restrictions against hedging or transferring the risk of these interests also would have increased the overall risk of their operations at the time such risks create exposure to U.S.

financial support through the Treasury Department's Senior Preferred Stock Purchase Agreement; and 4) requiring the Enterprises to hold these interests would not have increased the Enterprises' incentives to be vigilant about the credit quality of assets they securitize, since they guarantee 100 percent of that risk already.

More fundamentally, requiring the Enterprises to hold these interests would not create a "level playing field" between the Enterprises and private securitizations. The Enterprises' funding costs to hold these interests are, because of the perception of a government guarantee, lower than the costs their private competitors face to hold the same interests, and the Enterprises enjoy other cost advantages from the scale of their operations, which is generated by investor demand for their fully-guaranteed ABS. These differences translate into the Enterprises' ability to offer mortgage originators better prices for their mortgage loans, even if they were required to retain the additional five percent interest. Even with respect to the retention-exempt QRMs, the Enterprises' QRM securitizations will be more attractive to investors from a credit risk standpoint than a private-label QRM, due to the Enterprises' 100 percent guarantee of their QRM securitizations. These are larger issues that cannot be reached through the risk retention rule. However, Congress has begun to consider fundamental questions about the future structure and role of the Enterprises, and the Agencies have committed to revisit and change the retention approach for the Enterprises as appropriate when those changes occur.

## III. Conclusion

The role of securitization in our nation's interlinked facilities for taking on and distributing credit risk is an important one, and when done correctly, securitization

contributes to sustainable growth by improving market liquidity and credit availability. But these goals will falter – as we have seen – if securitization markets are built on a quicksand of shoddy assets. The risk retention proposal is designed to implement the Congressional directive to insure that securitizers have "skin in the game" to incentivize diligence regarding the quality of the loans they securitize. Against that backdrop, the proposal's exemptions from the risk retention requirements focus on demonstrably high quality loans, and the proposal seeks to provide flexibility for how the risk retention requirement may be satisfied. These are complex issues with multiple public policy implications. Achieving the right balance will be very challenging. The OCC looks forward to the input the Agencies will receive in the comment process to help get that balance right.

I appreciate the opportunity to appear before the Subcommittee this afternoon, and look forward to addressing your questions. Thank you.

**AMERICAN BANKERS ASSOCIATION**

**STATEMENT FOR THE RECORD**

**CAPITAL MARKETS SUBCOMMITTEE OF THE HOUSE FINANCIAL SERVICES COMMITTEE**

**HEARING ON PROPOSED RISK RETENTION RULES**

**APRIL 14, 2011**

The American Bankers Association is pleased to submit the following statement for the record for the Capital Markets Subcommittee hearing on proposed new risk retention rules required under Section 941 of the Dodd/Frank Act.

The ABA believes that the newly proposed rules are significantly flawed and are likely to drive many community banks out of mortgage lending if widely applied.

The housing and mortgage markets have been battered in recent years and are still struggling to recover. Addressing the systemic problems which led to the crisis is critical, but care must be taken to avoid unnecessary actions that do not address systemic issues and which could further destabilize the fragile recovery. ***We have grave concerns that the risk retention proposal recently issued by the regulators will drive community banks from mortgage lending and shut many borrowers out of the credit market entirely.*** It is true that the proposal's immediate impact is muted by the fact that loans sold to Fannie Mae and Freddie Mac while they are in conservatorship escape risk retention. However, once the rule's requirements are imposed broadly on the market (should they be adopted) they would shut out many borrowers entirely and act to destabilize an already fragile market. Since it is also the stated goal of both the Congress and the Administration to end the conservatorship of Fannie and Freddie, it is important that risk retention requirements be rational and non disruptive when they are applied broadly to the market. The rule as proposed does not meet those tests.

Therefore, ABA urges Congress to ensure that the regulators revise the risk retention regulation before it is imposed on the mortgage market broadly. Specifically we recommend:

- ***Exemptions from risk retention provisions must reflect changes in the market already imposed through other legislative and regulatory change.***

In the Dodd-Frank Act, Congress determined that some form of risk retention was desirable to ensure that participants in a mortgage securitization transaction had so-called "skin in the game." The goal was to create incentives for originators to assure proper underwriting (e.g., ability to repay) and incentives to control default risk for participants beyond the origination stage. There have already been dramatic changes to the regulations governing mortgages.[1] The result is that mortgage loans with lower risk characteristics – ***which include most mortgage loans being made by community banks today*** – should be exempted from the risk retention requirements – regardless of whether sold to Fannie Mae and Freddie Mac or to private securitizers. Exempting such "qualified residential mortgage" loans (QRM) is important to ensure the stability and recovery of the mortgage market and also to avoid capital requirements not necessary to address systemic issues. However, ***the QRM as proposed is very narrow and many high-quality loans posing little risk will end up being excluded. This will inevitably mean that fewer borrowers will qualify for loans to purchase or refinance a home.***

For example, for the loan to qualify, borrowers must make at least a 20 percent down payment – and at least 25 percent if the mortgage is to be a refinance (and 30 percent if it is a cash-out refinance).

Certainly loans with lower loan-to-value (LTV) ratios are likely to have lower default rates, and we agree that this is ***one*** of a ***number*** of characteristics to be considered. However, the LTV should not be the ***only*** characteristic for eligibility as a "Qualified Residential Mortgage," and it should not be considered in isolation. Setting the QRM cutoff at a specific LTV without regard to other loan characteristics or features, including credit enhancements such as private mortgage insurance, will lead to an unnecessary restriction of credit. To illustrate the severity of the proposal, even with ***private mortgage insurance,*** loans with less than 20 percent down will ***not*** qualify for the QRM.

ABA strongly believes that creating a narrow definition of QRM is an inappropriate method for achieving the desired underwriting reforms intended by Dodd-Frank.

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[1] For example, changes have been made under the Real Estate Settlement Procedures Act (RESPA), the Truth in Lending Act (TILA), and the Secure and Fair Enforcement for Mortgage Licensing (SAFE) Act. In addition, the federal bank agencies have just announced significant changes to appraisal standards.

- ***The Risk Retention Requirements as proposed will inhibit the return of private capital to the marketplace and will make ending the conservatorship of Fannie Mae and Freddie Mac more difficult.***

  The proposal presented by the regulators will make it ***vastly more difficult to end the conservatorship of Fannie and Freddie*** and to ***shrink FHA*** back to a more rational portion of the mortgage market. As we observed earlier, under the proposed rule, loans with a federal guarantee are exempt from risk retention – including loans sold to Fannie Mae and Freddie Mac while they are in conservatorship. Because of their conservatorship status, the GSEs have the backing of the federal government. FHA loans (as well as other federally insured and guaranteed loan programs) are also exempt. Since almost 100 percent of new loans being sold today are bought by Fannie and Freddie or insured by FHA – and as long as these GSEs can buy loans without risk retention – it will be dramatically more difficult for private securitizers to compete. In fact, the economic incentives of the proposed risk retention strongly favor sales of mortgages to the GSEs in conservatorship and not to private securitizers. Thus, this proposal does not foster the growth of private label securitizations that would reduce the role of government in backing loans.

  Equally important is the fact that the conservatorship situation is unsustainable over the long term. That means that eventually these highly narrow and restrictive rules would apply to a much, much larger segment of the mortgage market. That means that fewer borrowers will qualify for these QRM mortgage loans and the risk retention rules make it less likely that community banks will underwrite non-QRM – ***but prudent and safe*** – loans. Some community banks may stop providing mortgages altogether as the requirements and compliance costs make such a service unreasonable without considerable volume. Driving community banks from the mortgage marketplace would be counterproductive as they have proven to be responsible underwriters that have served their borrowers and communities well.

The imposition of risk retention requirements to improve underwriting of mortgage loans is a significant change to the operation of the mortgage markets and must not be undertaken lightly. ***ABA urges Congress to exercise its oversight authority to assure that rules adopted are***

***consistent with the intent of the statute and will not have adverse consequences for the housing market and mortgage credit availability.***

There are other related concerns affecting housing that need to be addressed by Congress as well. In particular, Congress needs to make the "Qualified Mortgage" in Title XIV a true safe harbor and ensure that it does not unnecessarily constrict credit. Title XIV of Dodd-Frank sets out new consumer protections for mortgage loans. As defined in Title XIV, a Qualified Mortgage (QM) is one which has specific features and is underwritten in such a way that it is presumed to meet these consumer protection standards. That presumption, however, can be rebutted – subjecting the lender to significant potential liability. The Qualified Mortgage definition (as set in statute and as refined through regulation) also serves as a limitation on the Qualified Residential Mortgage (QRM) standard discussed above because the QRM cannot be broader than the QM. As the law stands now, the Federal Reserve Board (and eventually the CFPB after the transfer of powers) can unilaterally narrow both the QM and QRM.

To avoid inadvertent and unintended impacts on safety and soundness as well as credit availability, ABA strongly urges Congress to require that any changes which could narrow the eligibility requirements for the QM be undertaken jointly with the regulators responsible for determining eligibility under the QRM.



EDUCATION FINANCE COUNCIL

**Statement for the Record from Education Finance Council**

**For the Hearing "Understanding the Implications and Consequences of the Proposed Rule on Risk Retention"**

**House Financial Services Committee,**
**Capital Markets and Government Sponsored Enterprises Subcommittee**

April 14, 2011

The Education Finance Council (EFC) is the trade association representing state agency and nonprofit student finance organizations. Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) created Section 15G of the Securities and Exchanges Act of 1934 which requires the securitizer of asset-backed securities to retain not less than five percent of the credit risk of the assets collateralizing the asset-backed securities. To implement this risk retention requirement, Section 15G directs six regulatory agencies, including the Federal Reserve and Securities and Exchange Commission to jointly promulgate a rule that sets out the forms of credit risk retention as well as any exemptions (hereafter, the "risk retention rule"). The regulatory agencies released a draft risk retention rule for public comment on March 31, 2011.[1]

EFC appreciates the importance of issuers of securitizations retaining some risk to align their interests with those of investors. In other words, state agency and nonprofit student finance organizations support appropriate "skin in the game." In that regard, EFC supports a risk retention rule that acknowledges the fact that all state agency and nonprofit student lenders currently and historically have utilized securitization structures that provide ample retained risk. EFC is hopeful that the final risk retention rule would not require any additional risk retention above what investors and the market presently demand. The result of additional risk retention would not provide investors with greater protection and would bring unnecessary financial distress to state agency and nonprofit student finance organizations.

The draft rule's exemption for certain types of state agency and nonprofit student lenders should be revised to reflect the rule's intent. The draft risk retention rule properly grants total exemption for state agency and nonprofit student lenders that utilized tax-exempt funding pursuant to section 150(d) of the Internal Revenue Code, based upon language in 941(b) of Dodd-Frank.[2] However, the draft rule inexplicably stops short of granting any exemption for nonprofit student lenders that do not or cannot issue bonds under section 150(d). By doing this, the draft rule makes an erroneous distinction between those nonprofit lenders that use 150(d) and those who do not; when securitizations by both types offer

[1] Securities and Exchange Commission, File No. S7-14-11
[2] See, SEC draft risk retention rule at p.105 which describes the authority from Dodd-Frank to grant a partial or total exemption for municipal and 150(d) issuers.





the exact same high level of retained risk. For example, all state agency and nonprofit student loan providers do not utilize bankruptcy-remote, special purpose vehicles (SPVs) when doing securitizations. The simple explanation for this is the fact that nonprofit and state agency student lenders are not "monied businesses" as the phrase is used in the Bankruptcy Code; which means the structures they use are exempt from involuntary bankruptcy under the Code. The practical effect of not using SPVs is that the securitizations remain "on the books" of these issuers, irrespective if they are a state agency, 150(d) nonprofit, or other state designated nonprofit student loan organization. Thus, EFC believes that the final risk retention rule should extend the exception for 150(d) nonprofit student lenders to *all* nonprofit student lenders.

The legislative intent behind the risk retention requirement in section 941 of Dodd-Frank is clearly directed at addressing securitizations that carry a far greater risk to investors than do student loan securitizations, especially those executed by state agency and nonprofit student loan providers. EFC believes that the final risk retention rule must not inhibit an environment in which these issuers are able to use securitizations to originate new loans or refinance existing bonds. To do this, the final rule must grant a total exemption for state agency, 150(d) and other nonprofit student lenders from risk retention.

# HVP Inc.

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April 14, 2011

Statement by James M. Connolly, President and CEO of HVP Inc.
for the House Subcommittee on Capital Markets and Government Sponsored Entities on
"Understanding the Implications and Consequences of the Proposed Rule on Risk Retention"

**HVP Inc.'s Private Sector Solution to Reducing the Risk of Mortgage Default and the Proposed Qualified Residential Mortgage Rule**

Mr. Chairman, I am pleased to submit this statement on behalf of HVP Inc. for inclusion in the record for the Capital Markets and Government Sponsored Entities Subcommittee hearing to evaluate the administration's recently proposed Credit Risk Retention Rule.

Home Value Protection, Inc. (HVP Inc.) is a private, Massachusetts-based holding company[1] that has developed a specific combination of insurance products that has been specifically designed to protect homebuyers, reduce mortgage defaults, and protect mortgage-backed securities investors. HVP's products are comprised of a combination of ***Financial Guaranty Insurance*** policies, which are designed to protect and benefit homeowners, and ***Credit Insurance*** policies, which are designed to protect and benefit lenders. Unlike any other products on the market these insurance policies (1) alleviate income shock by paying six monthly mortgage payments to lenders on behalf of unemployed policyholders and (2) cure illiquidity by paying homeowners for losses in market value including their down payments. All of HVP's policies treat negative equity by insuring losses below the face value of mortgages. The combination serves to protect the mortgage-backed securities investor.

HVP's products are not mortgage insurance

While the administration's proposed rule seeks to ensure that QRMs "are of very high credit quality," it does so through very prescriptive and rigid requirements that will stifle the availability of affordable credit and raise the cost of home buying for the vast majority of Americans through higher interest rates and fees. The requirement of 20% down, 80% LTV, and tight debt-to-income ratios will mean that established, older, high-income earners will qualify for the most affordable mortgages that carry the QRM designation.

We should not repeat the mistakes made in the past that led us to the mortgage and financial crisis we have been experiencing, but I believe that we should allow for market-based, private-

[1] HVP Inc. intends to form a licensed Financial Guarantee Insurance company that will offer the described products.

sector solutions in the form of new products that can address and mitigate the three primary causes of homeowner defaults: negative equity, income shock, and illiquidity. I am submitting this statement to the Subcommittee to make you aware that HVP Inc. has developed such a solution in the form of a suite of affordable insurance products – radically different from private mortgage insurance – that directly address these three causes of default.

HVP Inc.'s home value protection insurance products have been developed specifically in response to the alarming default and walk-away rate experienced in the recent real estate and national economic downturn. As the founders of HVP Inc., my partner Professor John Marthinsen and I realized the marketplace was failing to provide homeowners with the means to protect their investments from market value decline. In response, we developed a home value protection insurance product line to provide homeowners with protection against a decline in home values and specifically to prevent defaults that stem from a decline in home values even beyond the point where mortgage holders may be underwater.

Here's how the HVP Inc. insurance products work.

**HVP Inc.'s Three Insurance Products that Protect Homeowners from Market Risk**

1) *Home Price 20Protection Policy (HomPric20)* -- Insures the top 20% of a home's purchase price. In Policy Years 1 and 2, coverage is provided on 5% and 10% of purchase price respectively, and, thereafter, maximum coverage is provided at 20%.

   Example: A home purchased for $100,000 or whose fair market price is $100,000 upon refinancing is protected fully by HomPric20 until its market price falls below $80,000.

2) *Home Price 30Protection Policy (HomPric30)* – Insures the top 30% of a home's purchase price. In Policy Years 1 and 2, coverage is provided on 7½% and 15% of purchase price, respectively, and, thereafter, maximum coverage is provided at 30%.

   Example: A home purchased for $100,000 or whose fair market price is $100,000 upon refinancing is protected fully by HomPric30 until its market price falls below $70,000.

3) *Mortgage Face 20 Protection Policy (MorFac20)* -- Insures the top 20% of a mortgage's face value. In Policy Years 1 and 2, coverage is provided on 5% and 10% of mortgage loan face value respectively, and thereafter, full coverage is provided at 20%.

   Example: A home purchased for $100,000 or whose fair market price is $100,000 upon refinancing with a $90,000 mortgage (i.e., a 10% down payment) is protected by MorFac20 for any price reduction between $90,000 and $72,000 (i.e., 80% of the $90,000 mortgage).

**By Protecting Homeowners from Market Risk, HVP's Home Value Protection Policies Prevent Defaults**

Currently, when a mortgage loan is underwater (the market value of the home is less than the mortgage balance) there is a financial incentive for the owner to walk away. However, if a homeowner has purchased home value protection insurance (any of HVP Inc's three policies -

HomPric20, HomPric30, or MorFac20), the owner can: 1) sell the house at a loss, collect on the home value protection insurance policy, and pay off the mortgage without suffering any of the crippling credit history penalties associated with defaulting; or 2) wait out the market decline and stay in the house knowing his or her investment is insurance-protected against market loss.

Two of HVP Inc.'s policies, HomPric20 and HomPric30, restore a homeowner's entire liquidity by returning the loss in market value, including the down payment, up to the policy limit. The third policy pays for losses below the mortgage amount up to the policy limit.

**HVP Inc.: Default Prevention Forbearance:**

Should an HVP Inc. policyholder lose his/her income and be unable to make mortgage payments, the policyholder may apply for HVP Inc.'s Default Prevention Forbearance benefits. Upon verification of income loss and inability to pay (illiquidity and negative equity) HVP Inc. will assist the borrower to avoid default by paying the lender on behalf of the borrower up to a maximum of six monthly mortgage payments.

HVP Inc. will be repaid, without interest, the full amount of forbearance payments made on behalf of the borrower upon either the sale or refinancing of the house, or at mortgage term. In the case of subsequent foreclosure, the amount advanced by HVP Inc. will be credited against the insurance policy payout to the lender at settlement.

HVP Inc.'s commitment to make mortgage payments to lenders when its policyholders would otherwise default adds an important new benefit to HVP's suite of products.

**HVP Inc.'s Default Prevention Outreach Program**

HVP Inc. will provide an aggressive default-prevention outreach program to its policyholders advising them on how to protect their good credit and either stay in their house or pay off the mortgage free and clear through a sale and HVP Inc. insurance payout. It is in HVP Inc.'s interest to work with policyholders and guide them through their options to prevent defaults.

**Dodd-Frank Section 941(b): Meeting the Qualified Residential Mortgage Exemption Test**

Section 941(b) of the Dodd-Frank Act introduces a 5% credit-risk retention provision to discourage lenders from making and securitizing risky loans. The Act also encourages market-oriented solutions to reduce homeowner defaults. In particular, the act waives the 5% "skin-in-the-game" provision if a mortgage is supported by insurance or credit enhancement that "reduces the risk of homeowner default."

Studies have proven that there are three primary reasons for mortgage defaults: negative equity, income shock, and illiquidity. HVP Inc. addresses all three.

1) HVP Inc.'s financial guaranty insurance policies, which protect home and mortgage values against market declines, address negative equity by substantially lowering the threshold at which it is economically advantageous to walk away from an underwater mortgage.

2) In the case of income loss for an HVP Inc. policyholder, HVP Inc. will prevent default by paying the lender up to a maximum of six mortgage payments. HVP Inc. will be repaid its forbearance payments, in most cases, upon the sale of the house.

3) Two of HVP Inc's policies, HomPric20and HomPric30, address illiquidity by returning to policyholders both their down payment and additional market losses up to the policy limit. The third policy, MorPric20, restores to the policyholder the value he/she has built through a reduction in mortgage principal.

There are numerous reliable studies that confirm the position that negative equity, income shock, and illiquidity are the primary reasons for mortgage defaults. Six are attached.

***HVP Inc.'s products reduce the risk that borrowers will default on their mortgages, and, therefore, should be deemed to meet the "qualified residential mortgage" designation under Section 941 of the Dodd-Frank Act.***

Again, thank you for the opportunity to present this statement for the Subcommittee record.

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**David L. Bazelon Center for Mental Health Law**
**Center for Responsible Lending**
**Empire Justice Center**
**Kirwan Institute for the Study of Race and Ethnicity**
**Lawyers' Committee for Civil Rights Under Law**
**NAACP**
**NAACP Legal Defense and Educational Fund, Inc.**
**National Association of Consumer Advocates**
**National Council of La Raza**
**National Gay and Lesbian Task Force Action Fund**
**National Fair Housing Alliance**
**National People's Action**
**Neighborhood Economic Development Advocacy Project (NEDAP)**
**The Opportunity Agenda**
**PolicyLink**
**Poverty & Race Research Action Council**

April 5, 2011

The Honorable Spencer Bachus
Chairman, Committee on Financial Services
U.S. House of Representatives
2246 Rayburn House Office Building
Washington, DC 20515

The Honorable Scott Garrett
Chairman, Financial Services
Subcommittee on Capital Markets and
Government Sponsored Enterprises
U.S. House of Representatives
2244 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Bachus and Chairman Garrett:

On behalf of the undersigned organizations, we write urging you to abandon the piecemeal approach to GSE reform discussed at the March 31st House Financial Services Capital Markets and Government Sponsored Enterprises Subcommittee hearing, "Immediate Steps to Protect the Taxpayer from the Ongoing Bailout of Fannie Mae and Freddie Mac," and included in the eight bills discussed during the hearing. In order to serve best the needs of middle class and working class home seekers and homeowners across the country, we believe that Congress must approach the reform of the housing finance market in a well-directed and comprehensive manner.

Our national interest demands a housing finance system that provides opportunities that are appropriate for the circumstances of American families and individuals. Families who are financially ready to own a home must have the opportunity to do so, and must have access to the best credit for which they qualify. They should not be denied access to the appropriate mortgage because of where they live, be it in an urban area or a rural area, nor should they be denied access to the appropriate mortgage because of their race or national origin or those of their neighbors. Moreover, we need a robust market for financing well-located, affordable rental

housing that meets the needs of renters who seek good jobs, good schools, and access to municipal services.

Housing is more than just a commodity – it is where we live and has always been the cornerstone for building wealth in this country. The private market, left to its own devices, has historically failed to meet these objectives and left major parts of the housing market underserved. A piecemeal approach to reforming the secondary market, that includes attempts to weaken our already uncertain housing market and to move it into private hands, will only serve to perpetuate disparities and eliminate the government oversight we need to assure fair play and practices. As we heard during the hearing, a wide spectrum of consumer, civil rights and industry groups and Members of Congress are wary of the impacts of a piecemeal approach, and call instead for a deliberate and sensible discussion about the future of our housing finance system.

We, too, ask that the committee seek a comprehensive approach to housing finance reform that will further the federal government's housing policy objectives of promoting residential integration, eliminating housing discrimination, and providing safe, decent, and affordable housing for all.

Thank you for your consideration. Please direct any questions or suggestions to Deidre Swesnik of the National Fair Housing Alliance at (202) 898-1661 or dswesnik@nationalfairhousing.org.

Sincerely,

David L. Bazelon Center for Mental Health Law
Center for Responsible Lending
Empire Justice Center
Kirwan Institute for the Study of Race and Ethnicity
Lawyers' Committee for Civil Rights Under Law
NAACP
NAACP Legal Defense and Educational Fund, Inc.
National Association of Consumer Advocates
National Council of La Raza
National Gay and Lesbian Task Force Action Fund
National Fair Housing Alliance
National People's Action
Neighborhood Economic Development Advocacy Project (NEDAP)
The Opportunity Agenda
PolicyLink
Poverty & Race Research Action Council

cc: Members of the Capital Markets and Government Sponsored Enterprises Subcommittee



**Questions for The Honorable Scott Alvarez, General Counsel, Board of Governors of the Federal Reserve System, from Representative Bill Posey:**

**1. Section 941 of the Dodd-Frank Act requires the "securitizer" to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. The securitizer is defined as "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly...to the issuer." The Agencies concluded that the securitizer was the "sponsor" of the ABS and, in footnote 42 of the NPR, designated the CLO investment advisor as the sponsor of a managed CLO by declaring that "the CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool and then manages the securitized assets once deposited in the CLO structure." While an investment advisor is typically involved in the initiation and origination of a CLO, it does not do so by selling or transferring assets to the issuer. Rather, as noted by the NPR itself, the manager selects assets to be purchased on behalf of the issuer from many different sellers. If the plain language expresses Congressional intent to have the seller of the assets retain the risk, how did the agencies determine that the CLO manager (as someone that selects the loans to be purchased) should be the retainer of risk? These sound like very different roles.**

On March 31, 2011, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the U.S. Securities and Exchange Commission ("Commission"), the Director of the Federal Housing Finance Agency, and the Department of Housing and Urban Development (collectively, the "Agencies") invited public comment on a proposal that would implement the risk retention requirements under section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). Section 941(b) generally provides for the Agencies to apply the risk retention requirement to a "securitizer" of an asset-backed security ("ABS"), with "securitizer" defined as (A) an issuer of ABS, or (B) a person who organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer (15 U.S.C. § 78o-11(a)(3)). The second prong of the "securitizer" definition is substantially identical to the definition of a "sponsor" of a securitization transaction in the Commission's Regulation AB governing disclosures for ABS offerings registered under the Securities Act of 1933. On this basis, the Agencies proposed that a "sponsor" of an ABS transaction would be a "securitizer" for the purposes of section 941(b), in a manner consistent with the definition of that term in the Commission's Regulation AB.

The sponsor typically plays an active and direct role in arranging a securitization transaction and selecting the assets to be securitized. As explained in the preamble to the proposed rules, in the context of collateralized loan obligations ("CLOs"), the CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool, and then managing the securitized assets once deposited in the CLO structure.

The Board and the other Agencies have received a number of comments on this proposal and are in the process of carefully considering those comments.

**2. You did not appear to consider the recommendations from the Federal Reserve Study, which explicitly recommended that the Agencies "consider the potential for other incentive alignment mechanisms." In particular, the Fed noted that the CLOs, "alignment is typically accomplished by compensating the CLO managers using a performance-based fee structure." Why were other forms of alignment of interest absent in the Proposed Rules?**

Section 941(b) of the Dodd-Frank Act generally requires that the Agencies jointly prescribe regulations that require a securitizer to retain not less than five percent of the credit risk for any asset that the securitizer, through the issuance of an ABS, transfers, sells, or conveys to a third party, unless an exemption from the risk retention requirements for the securities or transaction is otherwise available. Consistent with section 941(b), the proposed rules generally would require that a sponsor retain an economic interest equal to at least five percent of the aggregate credit risk of the assets collateralizing an issuance of ABS. In addition, the proposed rules would allow flexibility by providing several options sponsors may choose from in meeting the risk retention requirements. These permissible forms of risk retention are designed to take into account the heterogeneity of securitization markets and practices, and to reduce the potential for the proposed rules to negatively affect the availability and cost of credit to consumers and businesses.

As recommended in the Board's Report to the Congress on Risk Retention,[1] the Agencies, in developing the proposed rules, took into consideration the potential for other incentive alignment mechanisms to function as an alternative or a complement to the mandated risk retention requirement. Performance-based fees may help to align the interests of an asset manager, such as a CLO manager, and investors to a certain degree. However, a CLO manager's incentives to ensure proper underwriting of assets are different from those of a securitizer that is required to retain an economic interest in the credit risk of an asset under the Dodd-Frank Act. The Agencies have endeavored to create appropriate incentives for both the securitization sponsor and the originator(s) to maintain and monitor appropriate underwriting standards, respectively, without creating undue complexity. For example, the proposed rules permit a sponsor of a securitization to allocate a portion of its risk retention obligation to an originator that contributes a significant amount of assets to the underlying asset pool.

The Board and the other Agencies have specifically invited comment on whether each of the proposed forms of risk retention are appropriate and whether there are any kinds of securitizations for which a particular form of risk retention would not be appropriate. The Board and the other Agencies will take into consideration all comments in formulating the final rule, including comments regarding different possibilities for incentive alignment structures between the various participants in securitization markets.

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[1] See generally Report to the Congress on Risk Retention, Board of Governors of the Federal Reserve System, at 8 (October 2010), available at http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf.

**Questions to the FDIC, OCC, Federal Reserve, and SEC by Representative Bill Posey. Responses of SEC staff are submitted by Meredith Cross, Director of the Division of Corporation Finance.**

1) **Section 941 of the Dodd-Frank Act requires the "securitizer" to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. The securitizer is defined as "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly...to the issuer." The Agencies concluded that the securitizer was the "sponsor" of the ABS and, in the footnote 42 of the NPR, designated the CLO investment adviser as the sponsor of a managed CLO by declaring that "the CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool and then manages the securitized assets once deposited in the CLO structure." While an investment adviser is typically involved in the initiation and origination of a CLO, it does not do so by selling or transferring assets to the issuer. Rather, as noted by the NPR itself, the manager selects assets to be purchased on behalf of the issuer from many different sellers. If the plain language expresses Congressional intent to have the seller of the assets retain the risk, how did the agencies determine that the CLO manager (as someone that selects the loans to be purchased) should be the retainer of risk? These sound like very different roles.**

As you note, section 941 of the Dodd-Frank Act, which adds Exchange Act section 15G, requires any "securitizer" to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. The term "securitizer" is defined in section 15G(a)(3) as "(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer." As stated in the notice of proposed rulemaking (NPR), the Agencies noted that the second prong of this definition (part (B)) is substantially identical to the definition of "sponsor" in the Commission's Regulation AB governing disclosures for ABS offerings registered under the Securities Act of 1933. In light of this, the proposed rules provide that a "sponsor" of an ABS transaction is a "securitizer" for the purposes of section 15G, and defines the term "sponsor" in a manner consistent with the definition of that term in the Commission's Regulation AB.

The proposed rules would, as a general matter, require that a sponsor of a securitization transaction retain the required amount of credit risk of the securitized assets. As stated in the NPR, the Agencies believed that proposing to apply the risk retention requirement to the sponsor of the ABS is appropriate in light of the active and direct role that a sponsor typically has in arranging a securitization transaction and selecting the assets to be securitized.

As you note in your question, in footnote 42 of the NPR, the Agencies provide that in the context of collateralized loan obligations (CLOs), the CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool, and then manages the securitized assets once deposited in the CLO structure. This is consistent with the statutory text because a securitizer is defined, in part, as "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer." (emphasis added)

During the comment period, the staff has heard from trade associations and members of the public who assert that the definition of "securitizer" should be read narrowly and that the CLO manager is not a "sponsor" because the CLO manager does not actually (or directly) sell or transfer assets to the issuing entity. Some also assert that there is no "sponsor" in CLO transactions because the seller of the loans is often not the entity that "organizes and initiates" the transaction, which is the CLO manager. We will consider these comments carefully in connection with preparing a recommendation to the Commission for final rules, while noting that the statutory language defines a sponsor as a person that indirectly sells or transfers the assets collateralizing the asset-backed security. In this regard, the CLO manager generally acts as a sponsor in CLO transactions by indirectly selling and transferring such assets to the issuer (i.e., the issuing entity) because the CLO manager selects the commercial loans to be purchased by an agent bank or issuing entity for inclusion in the CLO collateral pool. Moreover, we note that a narrow reading of this provision could be contrary to the purposes of the statute because it would potentially allow all forms of securitizations to be structured so that no participant in the transaction would be considered to be a sponsor that is required to retain risk. Again, however, we will consider these comments along with other comments received in this rulemaking.

2) **You did not appear to consider the recommendations from the Federal Reserve Study, which explicitly recommended that the Agencies "consider the potential for other incentive alignment mechanisms." In particular, the Fed noted that for CLOs, "alignment is typically accomplished by compensating the CLO managers using a performance-based fee structure." Why were other forms of alignment of interest absent in the Proposed Rules?**

In making its recommendations to the Commission, the staff of the Commission together with the staff of our fellow regulators closely analyzed the Federal Reserve Board's "Report to the Congress on Risk Retention," released October 2010. In particular, the inter-agency staff working group considered and thoroughly discussed the alternatives mentioned in the report such as overcollateralization, subordination, third-party credit enhancements, representations and warranties, conditional cash flows, and other alternatives or complements to the statutory directive of credit risk retention (e.g., unfunded guarantees, fee structures, etc.).

As stated in the NPR, the options in the proposed rules are designed to take into account the heterogeneity of securitization markets and practices, and to reduce the potential for the proposed rules to negatively affect the availability and costs of credit to consumers and businesses. However, as also noted in the NPR, each of the permitted forms of risk retention included in the proposed rules is subject to terms and conditions that are intended to help ensure that the sponsor (or other eligible entity) retains an economic exposure equivalent to at least five percent of the credit risk of the securitized assets.

We note that while the Agencies did not include a performance-based fee structure option in the proposed rules, the NPR requests comment on other forms of risk retention that the Agencies should permit to satisfy the requirements of section 15G, which could include a performance-based fee structure. We look forward to analyzing the comment letters on the proposed rules, including the questions asked in the NPR, and will consider all comments received as we move forward with this interagency rulemaking.

**Response to questions from the Honorable Bill Posey**
**by the Federal Deposit Insurance Corporation**

**Q1: Section 941 of the Dodd-Frank Act requires the "securitizer" to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. The securitizer is defined as "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly... to the issuer." The Agencies concluded that the securitizer was the "sponsor" of the ABS and, in footnote 42 of the NPR, designated the CLO investment adviser as the sponsor of a managed CLO by declaring that "the CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool and then manages the securitized assets once deposited in the CLO structure." While an investment adviser is typically involved in the initiation and origination of a CLO, it does not do so by selling or transferring assets to the issuer. Rather, as noted by the NPR itself, the manager selects assets to be purchased on behalf of the issuer from many different sellers. If the plain language expresses Congressional intent to have the seller of the assets retain the risk, how did the agencies determine that the CLO manager (as someone that selects the loans to be purchased) should be the retainer of risk? These sound like very different roles.**

**A1:** The plain language of Section 941 of the Dodd-Frank Act requires the *entity that organizes the securitization be subject to risk retention requirements*. The market generally recognizes two ways of pooling assets for securitizations: balance sheet transactions and arbitrage transactions. Arbitrage transactions are securitizations where an organizing entity purchased the pooled assets on the open market, often on behalf of a special purpose vehicle (SPV). Because SPVs are not operating companies, a servicer or manager purchases the assets for securitization on behalf of the issuing SPV, either directly or through a depositor, which often is a non-operating special purpose entity.

Balance sheet transactions result when an entity "owns" the assets through origination, purchase or acquisition of title to the assets for securitization. For risk retention purposes, there should not be any distinction between an entity that owns assets through origination, purchase, or acquisition of title to the assets (*i.e.*, balance sheet transactions) and an entity that employs an agent to purchase the assets (*i.e.*, arbitrage transactions). In both cases, the organizing entity meets the definition of securitizer under the statute because it organizes and initiates asset-backed securities transactions by causing the sale or transfer of assets, either directly or indirectly, to the issuer. Therefore, the Agencies believed it would be appropriate to include the collateralized loan obligations (CLO) manager as well as other servicers or managers that organize arbitrage transactions as covered by the definition of "sponsor" for risk retention purposes.

The conclusion that Section 941 of the Dodd-Frank Act did not intend to exclude CLO transactions is further supported by paragraph (c)(1)(F), which requires the regulations adopted by the Agencies "establish appropriate standards for retention of an economic interest with respect to collateralized debt obligations . . ." The collateralized debt obligation category includes a broad variety of transactions, many of which are arbitrage transactions. The statutory

language supports the Agencies' understanding that Congress intended the risk retention requirements apply broadly to all structured transactions unless exempted by regulation.

The proposal sought comment on whether the Agencies appropriately implemented the terms "securitizer" and "originator." The Agencies are carefully reviewing comments on the proposed credit risk retention rules, including those regarding CLO transactions.

**Q2: You did not appear to consider the recommendations from the Federal Reserve Study, which explicitly recommended that the Agencies "consider the potential for other incentive alignment mechanisms." In particular, the Fed noted that for CLOs, "alignment is typically accomplished by compensating the CLO managers using a performance-based fee structure." Why were other forms of alignment of interest absent in the Proposed Rules?**

**A2:** For purposes of developing the various risk retention options under the proposed rule, the Agencies reviewed recent studies on securitization and risk retention that examined historical market practices. In general, those studies recognized the options presented in the proposal. The studies did not view performance-based compensation as a form of risk retention widely used in the market. Similarly, Section 941 does not recognize performance-based servicing or management fees as an appropriate form of risk retention. Performance-based fees vary widely, and there can be no assurance they would meet the risk retention requirements of paragraph (c)(1)(b), which specifies a minimum of 5 percent of the credit risk of the underlying asset pool.

The proposal sought comment on whether to permit other forms or amounts of risk retention. The Agencies are carefully reviewing the comments to determine what revisions, if any, are appropriate relative to the amount and manner of risk retention for securitization transactions.

Questions for the Record
Representative Bill Posey

1. *Section 941 of the Dodd-Frank Act requires the "securitizer" to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. The securitizer is defined as "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly . . . to the issuer." The Agencies concluded that the securitizer was the "sponsor" of the ABS and, in footnote 42 of the NPR, designated the CLO investment adviser as the sponsor of a managed CLO by declaring that "the CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool and then manages the securitized assets once deposited in the CLO structure." While an investment adviser is typically involved in the initiation and the origination of a CLO, it does not do so by selling or transferring assets to the issuer. Rather, as noted by the NPR itself, the manager selects assets to be purchased on behalf of the issuer from many different sellers. If the plain language expresses Congressional intent to have the seller of the assets retain the risk, how did the agencies determine that the CLO manager (as someone that selects the loans to be purchased) should be the retainer of risk? These sound like very different roles.*

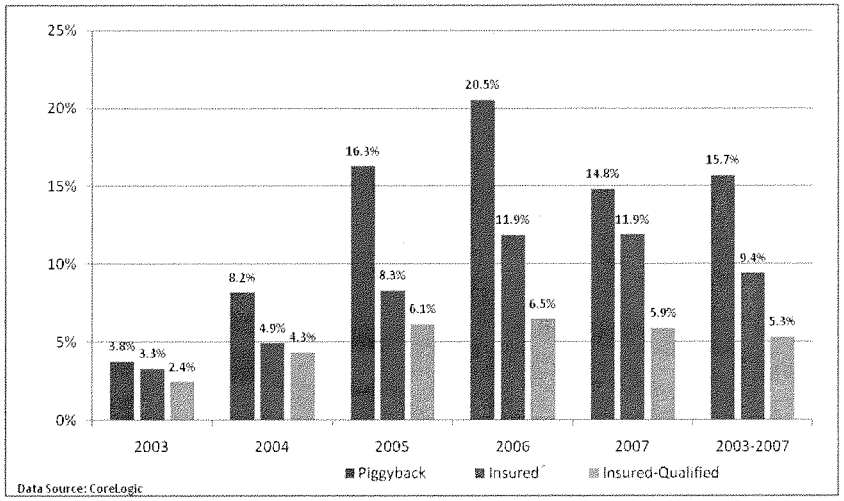
   As you point out, the CLO manager takes a significant role in organizing and initiating a CLO securities transaction. Part of this process, as discussed in the preamble and Federal Reserve Study, involves the CLO manager using an agent bank to purchase assets on its behalf for ultimate securitization. The actions of the CLO manager in selecting the assets and arranging for their transfer to the securitization issuer appear to fall within the statutory language covering "transferring assets, either directly *or indirectly* . . . to the issuer," which would make the CLO manager a "securitizer" under the definition laid out by Congress in Section 941. However, the Agencies are requesting public comment on whether the proposed regulatory definitions appropriately implement the statutory terms.

2. *You did not appear to consider the recommendations from the Federal Reserve Study, which explicitly recommended that the Agencies "consider the potential for other incentive alignment mechanisms." In particular, the Fed noted that for CLOs, "alignment is typically accomplished by compensating the CLO managers using a performance-based fee structure." Why were other forms of alignment of interest absent in the Proposed Rules?*

   The Agencies proposed forms of risk retention that are calibrated to align the interests of sponsors (including CLO managers), investors, and issuers. The Agencies believe these concrete and funded forms of risk retention achieve the directive of Section 941 to foster the securitization of well-underwritten assets. However, the Agencies have requested comment on whether the standards are properly calibrated, and what other options might be available to align interests to achieve the goals of Section 941.

# Qualified Insured Loan Performance

## NON-PERFORMING RATES*




## "Qualified" Insured Loans Have Performed Well Through the Downturn

* Non-Performing Rate: (# Loans Currently 90 or more days delinquent + loans that terminated in default ) / original number of loans